

RATE CASE EXPERIENCE OF JASON A. CASH					
No.	Year	Company	Commission	Case, Cause or Docket No.	Items Provided/Filed
9.	2019	AEP Texas Inc.	Public Utility Commission of Texas	Docket No. 49494	Testimony and Depreciation Study
10.	2019	Indiana Michigan Power Company	Indiana Utility Regulatory Commission	Cause No. 45235	Testimony and Depreciation Study
11.	2019	Indiana Michigan Power Company	Michigan Public Service Commission	Case No. U-20359	Testimony and Depreciation Study
12.	2019	Southwestern Electric Power Company	Arkansas Public Service Commission	Docket No. 19-008-U	Adopted the Testimony and Depreciation Study of Company witness David Davis in Addition to Filing Sur-Surrebuttal Testimony
13.	2020	Appalachian Power Company	Virginia State Corporation Commission	Case No. PUE-2020-00015	Testimony and Depreciation Study
14.	2020	Ohio Power Company	Public Utilities Commission of Ohio	Case No. 20-585-EL-AIR	Testimony and Depreciation Study
15.	2020	Appalachian Power Company	Public Service Commission of West Virginia	Case No. 20-0675-E-PC	Testimony

SOUTHWESTERN ELECTRIC POWER COMPANY

DEPRECIATION STUDY REPORT

OF

ELECTRIC PLANT IN SERVICE

AT DECEMBER 31, 2019

DEPRECIATION STUDY REPORT

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I. INTRODUCTION

This report presents the results of a depreciation study of Southwestern Electric Power Company's (SWEPCO or Company) depreciable electric utility plant in service at December 31, 2019. The study was prepared by Jason A. Cash, Accounting Senior Manager at American Electric Power Service Corporation (AEPSC). The purpose of the depreciation study was to develop appropriate annual depreciation accrual rates for each of the primary plant accounts that comprise the functional groups for which SWEPCO computes its annual depreciation expense.

The recommended depreciation rates are based on the Average Remaining Life Method of computing depreciation. Further explanation of this method is contained in Section II of this report.

The definition of depreciation used in my Study is the same as that used by the Federal Energy Regulatory Commission (FERC) and the National Association of Regulatory Utility Commissioners:

Depreciation, as applied to depreciable electric plant, means the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of electric plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities.

Service value means the difference between original cost and the net salvage value (net salvage value means the salvage value of the property retired less the cost of removal) of the electric plant.¹

¹ FERC Accounting and Reporting Requirements for Public Utilities and Licensees, ¶15.001.

Schedule I of this report shows the recommended depreciation accrual rates by primary plant accounts and by weighted average functional plant classifications. Schedule II compares depreciation expense using rates approved by the Commission and rates recommended by my depreciation study. Schedule III shows a comparison of the current study mortality characteristics that were used to compute the recommended depreciation rates and the mortality characteristics used to determine the existing depreciation rates and accruals for the Transmission, Distribution, and General Plant Functions. A comparison of SWEPCO's current functional group composite depreciation rates and accruals to the recommended functional group rates and accruals for electric plant in service as of December 31, 2019 follows:

Table 1 - Depreciation Rates and Accruals
Based on Plant In Service at December 31, 2019 (as adjusted)
(Total Company)

<u>Functional Plant Group</u>	<u>Existing</u>		<u>Study</u>		<u>Difference</u>
	<u>Rates</u>	<u>Accruals</u>	<u>Rates</u>	<u>Accruals</u>	
Production	2.33%	99,513,823	2.71%	115,877,699	16,363,876
Transmission	2.06%	42,285,974	2.33%	47,890,727	5,604,753
Distribution	2.33%	52,941,254	2.80%	63,573,769	10,632,515
General	3.52%	7,383,029	3.07%	6,441,093	(941,936)
Total Depreciable Plant	2.29%	202,124,080	2.65%	233,783,288	31,659,208

Note: The Dolet Hills Power Station was not included in the depreciation study and as a result is not included in the Production Plant function depreciation rates proposed in this case.

Based on total company depreciable plant in service as of December 31, 2019, adjusted as necessary for the units that were retired in 2020, the recommended depreciation rates are 0.36% higher than the existing rates and produce an increase in total company annual depreciation expense of \$31,659,208. The depreciation rate changes are necessary because of changes in average service lives and net salvage estimates used to calculate SWEPCO's current depreciation rates as discussed below.

II. DISCUSSION OF METHODS AND PROCEDURES USED IN THE STUDY

1. Group Method

All of the depreciable property included in this report was considered on a group plan methodology. Under the group plan, depreciation expense is accrued upon the basis of the original cost of all property included in each depreciable plant account. Upon retirement of any depreciable property, its full cost, less any net salvage realized, is charged to the accrued depreciation reserve regardless of the age of the particular item retired. Also, under this plan, the dollars in each primary plant account are considered as a separate group for depreciation accounting purposes and an annual depreciation rate for each account is determined. The annual accruals by primary account were then summed, to arrive at the total accrual for each functional group. The total accrual divided by the original cost yields the functional group accrual rate.

2. Determination of Annual Depreciation Rates by the Average Remaining Life Method

SWEPCO's current depreciation rates are based on the Average Remaining Life Method. The Average Remaining Life Method recovers the original cost of the plant, adjusted for net salvage, less accumulated depreciation, over the average remaining life of the plant. By this method, the annual depreciation rate for each account is determined on the following basis:

$$\begin{array}{l} \text{Annual} \\ \text{Depreciation Expense} = \\ \frac{(\text{Orig. Cost}) (\text{Net Salvage Ratio}) - \text{Accumulated Depreciation}}{\text{Average Remaining Life}} \end{array}$$

Annual

$$\text{Depreciation Rate} = \frac{\text{Annual Depreciation Expense}}{\text{Original Cost}}$$

3. Methods of Life Analysis

Depending upon the type of property and the nature of the data available from the property accounting records, one of three life analyses was used to arrive at the historically realized mortality characteristics and service lives of the depreciable plant investments. These methods are identified and described as follows:

Life Span Analysis

The life span analysis was employed for Production Plant. SWEPCO's investment in production plant includes steam and other generating plants. The life-span method of analysis is particularly suited to specific location property, such as a generating plant, where all of the surviving investments are likely to be retired in total at a future date.

The key elements in the life span analysis are the age of the surviving investments, the projected retirement date of the facility and the expected interim retirements. Interim retirements are those that are expected to occur between the date of the depreciation study and the expected final retirement date of the generating plant. Examples of interim retirements include fans, pumps, motors, a set of boiler tubes, a turbine rotor, etc.

For this SWEPCO depreciation study, the interim retirement history for each primary production plant account were **not** analyzed or included in the Production Plant analysis because the Commission indicated in its order in PUC Docket No. 40443 (Finding of Fact No. 195) that it is not reasonable

to include interim retirements in the calculation of production plant depreciation rates because the rate at which interim retirements will be made is not known and measurable.

The age of the surviving investments was obtained from SWEPCO's property accounting records. SWEPCO and American Electric Power Service Corporation (AEPSC) personnel provided the retirement dates used in the life-span analysis for Production Plant. A discussion of the life analyses for Production Plants follows:

Production Plant

SWEPCO's depreciable investments in Production Plant are Arsenal Hill, Knox Lee, Lieberman, Mattison, Stall and Wilkes plants, which are gas and oil fired, and Flint Creek, Pirkey, Welsh and Turk plants, which are coal and lignite fired. The generating units and their respective capacities are shown on Schedule IV of this report.

Since SWEPCO's last depreciation study (property investment dated December 31, 2015), SWEPCO retired Knox Lee Unit 4 in January 2019. Additionally in May 2020, SWEPCO retired the Lone Star Plant, Knox Lee Units 2 and 3, and Lieberman Unit 2. The effect of each of these retirements are included in the depreciation study. Excluding the Lone Star Plant and the Dolet Hills Power Station, SWEPCO added \$119.2 million to the original cost of its steam production plant since the last depreciation study.

Even though the Dolet Hills Power Station remains in service, all costs related to Plant are excluded for the purposes of calculating

depreciation rates. Please refer to the testimonies of Company witness Michael Baird and Company Witness Thomas Brice for more information on the proposed ratemaking for the remaining undepreciated value of the Dolet Hills Power Station.

The major steam plant additions since the last depreciation study are the primary reason for the higher recommended Production Plant depreciation rates when compared to the prior study's depreciation rates.

Actuarial Analysis – Transmission, Distribution and General Plant

This method of analyzing past experience represents the application to industrial property of statistical procedures developed in the life insurance field for investigating human mortality. It is distinguished from other methods of life estimation by the requirement that it is necessary to know the age of the property at the time of its retirement and the age of survivors, or plant remaining in service. In other words, the installation date must be known for each particular retirement and for each particular survivor.

The application of this method involves the statistical procedure known as the "annual rate method" of analysis. This procedure relates the retirements during each age interval to the exposures at the beginning of that interval, and the resulting ratio is the annual retirement ratio. Subtracting each retirement ratio from unity yields a sequence of annual survival ratios from which a survivor curve can be determined. This is accomplished by the consecutive multiplication of the survivor ratios. The length of this curve depends primarily upon the age of the oldest property. Normally, if the period of years from the inception of the account to the time

of the study is short in relation to the expected maximum life of the property, an incomplete or stub survivor curve results.

While there are a number of acceptable methods of smoothing and extending this stub survivor curve in order to compute the area under it from which the average life is determined, the well-known Iowa Type Curve Method was used in this study.

By this procedure, instead of mathematically smoothing and projecting the stub survivor curve to determine the average life of the group, it was assumed that the stub curve would have the same mortality characteristics as the type of curve selected. The selection of the appropriate type curve and average life is accomplished by plotting the stub curve, superimposing on it Iowa curves of the various types and average lives drawn to the same scale, and then determining which Iowa type curve and average life best matches the stub.

The Actuarial Method of Life Analysis was used for Transmission, Distribution, and General Plant account 390.

The result of the actuarial analysis for the above accounts is detailed in the depreciation study work papers.

Vintage Year Accounting – General Equipment

In 1996, the Company began using a vintage year accounting method for general plant accounts 391 to 398 in accordance with Federal Energy Regulatory Commission Accounting Release Number 15 (AR-15). This accounting method

requires amortization of vintage groups of property over their useful lives. AR-15 also requires that property be retired when it meets its average service life.

As a result, my recommendation for these accounts is that the current useful life approved by the Commission be retained and used to continue amortization of the account balances.

4. Final Selection of Average Life and Curve Type

The final selection of average life and curve type for each depreciable plant account analyzed by the Actuarial Method was primarily based on the results of the mortality analyses of past retirement history.

III. NET SALVAGE

1. Net Salvage - Production Plant

The net salvage analysis for production plant **excluded** a review of the Company's experienced functional interim retirement, salvage, and removal history since the Commission in PUC Docket No. 40443 (Finding of Fact, No. 195) indicated that it is not reasonable to include interim retirements in the calculation of production plant depreciation rates.

Although an analysis of interim retirements was not performed or included in the calculation of production plant depreciation rates, the final retirement/demolition cost for the Company's production plant was calculated and included. To assist in establishing total final net salvage (demolition cost less salvage) applicable to SWEPCO's generating plants, SWEPCO contracted with

Sargent & Lundy (S&L) to update the conceptual demolition cost estimates for plants that were included in SWEPCO's last depreciation study. The updated S&L cost estimates to demolish the plants are based on current (2020) price levels which were inflated to the retirement date in the depreciation study. Excluding the Dolet Hills Power Station, the estimate of demolition costs were incorporated into the net salvage ratios for Production Plant. S&L's demolition costs do not include Asset Retirement Obligation (ARO) amounts associated with the removal of asbestos or any cost associated with the final disposition of landfills and ash ponds since accretion and depreciation associated with these AROs is included separately in SWEPCO's cost of service.

2. Net Salvage – Transmission, Distribution and General Plant

The net salvage percentages used in this report for Transmission, Distribution and General Plant are expressed as percent of original cost and are based on the Company's experience combined with the judgment of the analyst. To determine gross salvage, gross removal, and net salvage percentages for individual plant accounts, original cost retirements, salvage and removal were detailed by account for the period 1984 through 2019. The gross salvage and cost of removal percentages were calculated for this 32-year period (1984 to 2019) for each account (history was not available for several accounts back to 1984). The salvage and removal percentages for each account were then netted to determine a net salvage percentage for each account.

The net salvage percentages were converted to net salvage ratios (1 minus the net salvage percentage). The net salvage ratios appear in Column IV on Schedule I and the ratios were used to determine the total amount to be recovered

through depreciation. The net salvage percentage for each account was reflected in the determination of the calculated depreciation requirement, which was used to allocate accumulated depreciation at the functional group to the accounts comprising each group.

3. Net Salvage – Ratios

The net salvage ratios shown in Column IV on Schedule I of this report may be explained as follows:

- a. Where the ratio is shown as unity (1.00), it was assumed that the net salvage in that particular account would be zero.
- b. Where the ratio is less than unity, it was assumed that the salvage exceeded the removal costs. For example, if the net salvage were 20%, the net salvage ratio would be expressed as .80.
- c. Where the ratio is greater than unity, it was assumed that the salvage was less than the cost of removal. For example, if the net salvage were minus 5%, the net salvage ratio would be expressed as 1.05.

IV. CALCULATION OF DEPRECIATION REQUIREMENT AT DECEMBER 31, 2019

The accumulated depreciation by functional group was allocated to individual plant accounts based on the calculation of a depreciation requirement (theoretical reserve) for each plant account using the average service life, curve type and net salvage amount recommended in this study.

V. STUDY RESULTS

Production, Transmission, Distribution, and General plant results are discussed below. In addition, Transmission, Distribution, and General Plant average service life, retirement dispersion pattern, and net salvage percentages used to calculate each primary plant account depreciation rate are shown on Schedule III. The mortality characteristics and net salvage values for the current rates are also shown. Changes to the mortality characteristics follow trends shown by historical retirement experience. Gross salvage and gross cost of removal percentages were largely based on history for each account for the period 1984-2019.

Production Plant

Depreciation rates for production plant increased from 2.33% to 2.71% (or 0.38%) and the annualized depreciation accrual increase due to the change in Production Plant depreciation rates was approximately \$16.4 million on a total company basis. The depreciation accrual increase was primarily due to an increase in the plant in service balance of \$119.2 million since depreciation rates were last changed.

As in the prior study, terminal demolition costs, excluding the Dolet Hills Power Station, are included in the depreciation rates. The estimates of terminal demolition costs were developed by Sargent & Lundy. The S&L estimated demolition costs for SWEPCO's Plants in 2020 pricing levels are provided in SWEPCO witness Paul. M. Eiden EXHIBIT PME-2.

Transmission Plant

The composite depreciation rate for Transmission Plant increased from 2.06% to 2.33% (or 0.27%) and the annualized depreciation expense accrual increase due to the change in depreciation rates was approximately \$5.6 million (see Table 1 above). The increase in Transmission Plant depreciation rates are due to increases in the net salvage ratio for three accounts (Accounts 352, 354, and 356) and decreases in the average service life for two accounts (Accounts 353 and 355). The depreciation rate increase was partially offset by decreases in the net salvage ratio for two accounts (Accounts 353 and 355) and an increase in the average service life for Account 352.

Distribution Plant

The composite depreciation rate for Distribution Plant increased from 2.33% to 2.80% (or 0.47%) and the annualized depreciation expense accrual increase due to the change in depreciation rates was approximately \$10.6 million (see Table 1 above). The increase in Distribution Plant depreciation rates are due to increases in the net salvage ratio for five accounts (Accounts 364, 365, 367, 368 and 373) and decreases in the average service life for three accounts (Accounts 367, 368, and 370). The depreciation rate increase was partially offset by decreases in the net salvage ratio for two accounts (Accounts 370 and 371) and an increase in the average service life for four accounts (Accounts 361, 362, 369, and 373). It should also be noted that Distribution Plant investment has increased by \$321.4 million from \$1,950.3 million in 2015 to \$2,271.7 million in 2019 (since the last depreciation study with plant in service balances at December 31, 2015). The composite depreciation rate for Distribution Plant increased from 2.09% to 2.38% (or 0.29%) and the accrual (depreciation expense) increase due to the

change in depreciation rates was approximately \$5.6 million (see Table 1 above).

General Plant

The composite depreciation rate for General Plant decreased from 3.52% to 3.07% (or 0.45%) mainly due to an increase in the average service life for account 390 from 55 years to 58 years.

SCHEDULE I – EXPLANATION OF COLUMN HEADINGS

Schedule I shows the determination of the recommended annual depreciation accrual rate by primary plant accounts by the straight line remaining life method. An explanation of the schedule follows:

Column I	-	Account number.
Column II	-	Account title.
Column III	-	Original Cost
Column IV	-	Net Salvage Ratio.
Column V	-	Total to be Recovered (Column III) * (Column IV).
Column VI	-	Calculated Depreciation Requirement.
Column VII	-	Allocated Accumulated Depreciation – SWEPCO's functional accumulated depreciation (book reserve) spread to each account on the basis of the Calculated Depreciation Requirement shown in Column VI.
Column VIII	-	Remaining to be Recovered (Column V - Column VII).
Column IX	-	Average Remaining Life.
Column X	-	Recommended Annual Accrual Amount.
Column XI	-	Accrual Percent or Depreciation Rate (Column X/Column III).

SOUTHWESTERN ELECTRIC POWER COMPANY
SCHEDULE I - CALCULATION OF DEPRECIATION RATES BY THE REMAINING LIFE METHOD
BASED ON PLANT IN SERVICE AT DECEMBER 31, 2019
AVERAGE LIFE GROUP (ALG) METHOD ACCRUAL RATES

TX										
Acct (I)	Title (II)	Original Cost (III)	Net Salvage Ratio (IV)	Total to be Recovered (V)	Calculated Depreciation Requirement (VI)	Allocated Accumulated Depreciation (VII)	Remaining to be Recovered (VIII)	Avg Remain Life (IX)	Annual Accrual Amount (X)	Accrual Percent (XI)
STEAM PRODUCTION PLANT (1)										
Gas & Oil Plants										
ARSENAL HILL										
311 0	Structures & Improvements	6,523,578	1 14	7,436,879	6,546,332	5,453,637	1,983,242	5.50	360,589	5.53%
312 0	Boiler Plant Equipment	7,190,747	1 14	8,197,452	7,068,326	5,888,501	2,308,951	5.50	419,809	5.84%
314 0	Turbogenerator Units	5,437,070	1 14	6,198,260	5,541,538	4,616,560	1,581,700	5.50	287,582	5.29%
315 0	Accessory Electrical Equipment	1,250,953	1 14	1,426,086	1,189,766	991,174	434,912	5.50	79,075	6.32%
316 0	Misc Power Plant Equip	<u>7,211,222</u>	1 14	<u>8,220,793</u>	<u>5,838,582</u>	<u>4,864,023</u>	<u>3,356,770</u>	5.50	<u>610,322</u>	8.46%
	Total	<u>27,613,570</u>	1 14	<u>31,479,470</u>	<u>26,184,544</u>	<u>21,813,895</u>	<u>9,665,575</u>		<u>1,757,377</u>	6.36%
KNOX LEE										
311 0	Structures & Improvements	9,069,087	1.45	13,150,176	8,813,487	7,342,365	5,807,811	19.50	297,836	3.28%
312 0	Boiler Plant Equipment	30,014,534	1.45	43,521,074	26,019,302	21,676,235	21,844,839	19.50	1,120,248	3.73%
314 0	Turbogenerator Units	15,603,354	1.45	22,624,833	13,940,122	11,613,277	11,011,586	19.50	584,697	3.62%
315 0	Accessory Electrical Equipment	4,663,877	1.45	6,762,622	3,717,099	3,096,652	3,665,970	19.50	187,998	4.03%
316 0	Misc Power Plant Equip	<u>2,008,192</u>	1.45	<u>2,911,878</u>	<u>1,358,770</u>	<u>1,131,988</u>	<u>1,779,910</u>	19.50	<u>91,277</u>	4.55%
	Total	<u>61,359,044</u>	1.45	<u>88,970,613</u>	<u>53,848,780</u>	<u>44,860,497</u>	<u>44,110,116</u>		<u>2,262,056</u>	3.69%
LIEBERMAN (2)										
311 0	Structures & Improvements	5,407,423	1 16	6,272,611	5,766,055	4,803,602	1,469,009	3.50	419,717	7.76%
312 0	Boiler Plant Equipment	19,379,730	1 16	22,480,487	20,314,140	16,923,362	5,557,125	3.50	1,587,750	8.19%
314 0	Turbogenerator Units	10,770,201	1 16	12,493,433	11,583,212	9,649,776	2,843,657	3.50	812,473	7.54%
315 0	Accessory Electrical Equipment	3,471,047	1 16	4,026,415	3,634,958	3,028,221	998,194	3.50	285,198	8.22%
316 0	Misc Power Plant Equip	<u>2,320,380</u>	1 16	<u>2,691,641</u>	<u>2,122,067</u>	<u>1,767,858</u>	<u>923,783</u>	3.50	<u>263,938</u>	11.37%
	Total	<u>41,348,781</u>	1.16	<u>47,964,587</u>	<u>43,420,432</u>	<u>36,172,819</u>	<u>11,791,768</u>		<u>3,369,076</u>	8.15%
STALL										
311 0	Structures & Improvements	54,049,867	1 02	55,130,864	12,711,809	10,589,990	44,540,874	30.50	1,460,357	2.70%
312 0	Boiler Plant Equipment	86,638,497	1 02	88,371,267	20,393,369	16,989,366	71,381,901	30.50	2,340,390	2.70%
314 0	Turbogenerator Units	167,305,849	1 02	170,651,966	36,262,992	30,210,078	140,441,888	30.50	4,604,652	2.75%
315 0	Accessory Electrical Equipment	39,669,289	1 02	40,462,675	9,571,271	7,973,662	32,489,013	30.50	1,065,214	2.69%
316 0	Misc Power Plant Equip	<u>83,804,940</u>	1 02	<u>85,481,039</u>	<u>20,105,620</u>	<u>16,749,648</u>	<u>68,731,391</u>	30.50	<u>2,253,488</u>	2.69%
	Total	<u>431,468,442</u>	1.02	<u>440,097,811</u>	<u>99,045,061</u>	<u>82,512,744</u>	<u>357,585,067</u>		<u>11,724,101</u>	2.72%
WILKES										
311 0	Structures & Improvements	8,345,659	1 09	9,096,768	6,656,577	5,545,480	3,551,288	14.70	241,584	2.89%
312 0	Boiler Plant Equipment	53,895,276	1 09	58,745,851	36,431,535	30,350,488	28,395,363	14.70	1,931,657	3.58%
314 0	Turbogenerator Units	37,889,001	1 09	41,299,011	28,052,329	23,369,915	17,929,096	14.70	1,219,666	3.22%
315 0	Accessory Electrical Equipment	10,316,197	1 09	11,244,655	6,022,019	5,016,841	6,227,814	14.70	423,661	4.11%
316 0	Misc Power Plant Equip	<u>9,145,772</u>	1 09	<u>9,968,891</u>	<u>4,288,739</u>	<u>3,571,209</u>	<u>6,397,682</u>	14.70	<u>435,216</u>	4.76%
	Total	<u>119,591,905</u>	1.09	<u>130,355,176</u>	<u>81,449,199</u>	<u>67,853,933</u>	<u>62,501,243</u>		<u>4,251,784</u>	3.56%
	Total Gas & Oil Plants	<u>681,381,742</u>	1.08	<u>738,867,657</u>	<u>303,948,016</u>	<u>253,213,888</u>	<u>485,653,769</u>	20.79	<u>23,364,394</u>	3.43%

SOUTHWESTERN ELECTRIC POWER COMPANY
SCHEDULE I - CALCULATION OF DEPRECIATION RATES BY THE REMAINING LIFE METHOD
BASED ON PLANT IN SERVICE AT DECEMBER 31, 2019
AVERAGE LIFE GROUP (ALG) METHOD ACCRUAL RATES

TX										
Acct.	Title	Original Cost	Net Salvage Ratio	Total to be Recovered	Calculated Depreciation Requirement	Allocated Accumulated Depreciation	Remaining to be Recovered	Avg Remain Life	Annual Accrual Amount	Accrual Percent
(I)	(II)	(III)	(IV)	(V)	(VI)	(VII)	(VIII)	(IX)	(X)	(XI)
Coal and Lignite Plants										
FLINT CREEK										
311 0	Structures & Improvements	27,330,924	1 03	28,150,852	16,590,569	13,821,319	14,329,533	18 50	774,569	2 83%
312 0	Boiler Plant Equipment	295,403,376	1 03	304,265,477	92,413,338	76,987,969	227,277,508	18 50	12,285,271	4 16%
314 0	Turbogenerator Units	15,318,616	1 03	15,778,174	8,829,919	7,356,054	8,422,120	18 50	455,250	2 97%
315 0	Accessory Electrical Equipment	10,970,647	1 03	11,299,766	5,515,437	4,594,816	6,704,950	18 50	362,430	3 30%
316 0	Misc Power Plant Equip	<u>6,259,411</u>	1 03	<u>6,446,163</u>	<u>3,393,065</u>	<u>2,826,704</u>	<u>3,619,459</u>	18 50	<u>195,646</u>	3 13%
	Total	<u>355,281,974</u>	1 03	<u>365,940,432</u>	<u>126,742,328</u>	<u>105,586,862</u>	<u>260,353,570</u>		<u>14,073,166</u>	3 96%
PIRKEY										
311 0	Structures & Improvements	109,344,557	1 05	114,811,785	64,360,285	53,617,451	61,194,334	25 50	2,399,778	2 19%
312 0	Boiler Plant Equipment	379,562,731	1 05	398,540,868	188,695,893	157,199,317	241,341,551	25 50	9,464,375	2 49%
314 0	Turbogenerator Units	50,950,757	1 05	53,498,295	29,985,601	24,980,491	28,517,804	25 50	1,118,345	2 19%
315 0	Accessory Electrical Equipment	18,401,272	1 05	19,321,336	9,628,358	8,021,220	11,300,116	25 50	443,142	2 41%
316 0	Misc Power Plant Equip	<u>19,401,615</u>	1 05	<u>20,371,696</u>	<u>10,245,414</u>	<u>8,535,279</u>	<u>11,836,417</u>	25 50	<u>464,173</u>	2 39%
	Total	<u>577,660,932</u>	1 05	<u>606,543,980</u>	<u>302,915,551</u>	<u>252,353,758</u>	<u>354,190,222</u>		<u>13,889,813</u>	2 40%
TURK										
311 0	Structures & Improvements	287,492,517	1 02	293,242,367	38,505,490	32,078,264	261,164,103	47 50	5,498,192	1 91%
312 0	Boiler Plant Equipment	992,441,092	1 02	1,012,289,914	136,287,529	113,538,806	898,751,108	47 50	18,921,076	1 91%
314 0	Turbogenerator Units	232,629,873	1 02	237,282,470	32,356,701	26,955,813	210,326,657	47 50	4,427,930	1 90%
315 0	Accessory Electrical Equipment	93,354,798	1 02	95,221,894	12,924,951	10,767,555	84,454,339	47 50	1,777,986	1 90%
316 0	Misc Power Plant Equip	<u>48,553,150</u>	1 02	<u>49,524,213</u>	<u>6,667,589</u>	<u>5,554,654</u>	<u>43,969,559</u>	47 50	<u>925,675</u>	1 91%
	Total	<u>1,654,471,430</u>	1 02	<u>1,687,560,858</u>	<u>226,742,260</u>	<u>188,895,092</u>	<u>1,498,665,766</u>		<u>31,550,859</u>	1 91%
WELSH										
311 0	Structures & Improvements	72,936,301	1 05	76,583,116	43,387,140	36,145,083	40,438,033	20 00	2,021,902	2 77%
312 0	Boiler Plant Equipment	583,599,604	1 05	612,779,584	241,847,633	201,479,120	411,300,464	20 00	20,565,023	3 52%
314 0	Turbogenerator Units	142,048,909	1 05	149,151,354	72,150,139	60,107,045	89,044,309	20 00	4,452,215	3 13%
315 0	Accessory Electrical Equipment	47,084,699	1 05	49,438,934	19,503,158	16,247,747	33,191,187	20 00	1,659,559	3 52%
316 0	Misc Power Plant Equip	<u>21,423,993</u>	1 05	<u>22,495,193</u>	<u>10,689,791</u>	<u>8,905,482</u>	<u>13,589,711</u>	20 00	<u>679,486</u>	3 17%
	Total	<u>867,093,506</u>	1 05	<u>910,448,181</u>	<u>387,577,861</u>	<u>322,884,477</u>	<u>587,563,704</u>		<u>29,378,185</u>	3 39%
	Total Coal and Lignite Plants	<u>3,454,507,842</u>	1.03	<u>3,570,493,451</u>	<u>1,043,978,000</u>	<u>869,720,189</u>	<u>2,700,773,262</u>	30.38	<u>88,892,023</u>	2 57%
RAIL CARS										
312 11	Rail Cars - Flint Creek	3,989,549	1 00	3,989,549	2,022,945	1,685,281	2,304,268	18 50	124,555	3 12%
312 11	Rail Cars - Welsh Plant	<u>12,114,203</u>	1 00	<u>12,114,203</u>	<u>5,547,844</u>	<u>4,621,814</u>	<u>7,492,389</u>	22 50	<u>332,995</u>	2 75%
	Total	<u>16,103,752</u>	1.00	<u>16,103,752</u>	<u>7,570,789</u>	<u>6,307,095</u>	<u>9,796,657</u>		<u>457,550</u>	2.84%
	Total Steam Production Plant	<u>4,151,993,336</u>	1.04	<u>4,325,464,860</u>	<u>1,355,496,805</u>	<u>1,129,241,172</u>	<u>3,196,223,688</u>	28.36	<u>112,713,967</u>	2 71%
Other Production Plant										
MATTISON										
341 0	Structures & Improvements	30,793,285	1 07	32,948,815	9,115,374	7,593,862	25,354,953	32.50	780,152	2 53%
344 0	Generators	84,008,692	1 07	89,889,300	24,925,941	20,765,375	69,123,925	32 50	2,126,890	2 53%
345 0	Accessory Electrical Equip	8,998,287	1 07	9,628,167	2,431,400	2,025,558	7,602,609	32.50	233,926	2 60%
346 0	Misc Power Plant Equip	<u>829,903</u>	1 07	<u>887,996</u>	<u>177,861</u>	<u>148,172</u>	<u>739,824</u>	32 50	<u>22,764</u>	2 74%
	Total	<u>124,630,167</u>	1 07	<u>133,354,278</u>	<u>36,650,576</u>	<u>30,532,967</u>	<u>102,821,311</u>		<u>3,163,732</u>	2 54%
	Total Other Production Plant	<u>124,630,167</u>		<u>133,354,278</u>	<u>36,650,576</u>	<u>30,532,967</u>	<u>102,821,311</u>	32.50	<u>3,163,732</u>	2.54%
	Total Production Plant	<u>4,276,623,503</u>	1.04	<u>4,458,819,138</u>	<u>1,392,147,381</u>	<u>1,159,774,139</u>	<u>3,299,044,999</u>	28.47	<u>115,877,699</u>	2.71%

SOUTHWESTERN ELECTRIC POWER COMPANY
SCHEDULE I - CALCULATION OF DEPRECIATION RATES BY THE REMAINING LIFE METHOD
BASED ON PLANT IN SERVICE AT DECEMBER 31, 2019
AVERAGE LIFE GROUP (ALG) METHOD ACCRUAL RATES

TX

Acct (I)	Title (II)	Original Cost (III)	Net Salvage Ratio (IV)	Total to be Recovered (V)	Calculated Depreciation Requirement (VI)	Allocated Accumulated Depreciation (VII)	Remaining to be Recovered (VIII)	Avg Remain Life (IX)	Annual Accrual Amount (X)	Accrual Percent (XI)
TRANSMISSION PLANT										
350 1	Land Rights	98,424,907	1 00	98,424,907	22,347,177	27,572,110	70,852,797	54 11	1,309,421	1 33%
352 0	Structures & Improvements	25,073,646	1 07	26,828,801	4,303,852	5,310,124	21,518,677	58 77	366,151	1 46%
353 0	Station Equipment	702,710,223	1 09	765,954,143	115,586,136	142,611,017	623,343,126	57 74	10,795,690	1 54%
354 0	Towers & Fixtures	40,325,282	1 18	47,583,833	21,689,004	26,760,051	20,823,782	35 37	588,741	1 46%
355 0	Poles & Fixtures	759,166,339	1 64	1,245,032,796	189,901,237	234,301,530	1,010,731,266	38 98	25,929,483	3 42%
356 0	OH Conductor & Devices	426,450,498	1 53	652,469,262	115,634,354	142,670,509	509,798,753	57 79	8,821,574	2 07%
357 0	Underground Conduit	3,826,324	1 00	3,826,324	80,951	99,878	3,726,446	48 94	76,143	1 99%
358 0	Underground Conductor & Devices	87,633	1 00	87,633	2,203	2,718	84,915	48 74	1,742	1 99%
359 0	Roads and Trails	<u>131,947</u>	1 00	<u>131,947</u>	<u>45,237</u>	<u>55,815</u>	<u>76,132</u>	42 72	<u>1,782</u>	3 35%
Total Transmission Plant		2,056,196,799	1 38	2,840,339,646	469,590,151	579,383,752	2,260,955,894	47.21	47,890,727	2.33%
DISTRIBUTION PLANT										
360 1	Land Rights	3,593,142	1 00	3,593,142	1,744,524	2,034,542	1,558,600	30 87	50,489	1 41%
361 0	Structures & Improvements	9,551,154	1 11	10,601,781	1,769,915	2,064,155	8,537,626	62 48	136,646	1 43%
362 0	Station Equipment	331,732,959	1 16	384,810,232	77,322,253	90,176,696	294,633,536	45 55	6,468,354	1 95%
364 0	Poles, Towers, & Fixtures	470,031,668	1 64	770,851,936	184,376,428	215,028,099	555,823,837	41 84	13,284,509	2 83%
365 0	Overhead Conductor & Devices	474,074,113	1 40	663,703,758	151,550,416	176,744,924	486,958,834	33 95	14,343,412	3 03%
366 0	Underground Conduit	71,650,932	1 00	71,650,932	15,022,332	17,519,720	54,131,212	55 32	978,511	1 37%
367 0	Underground Conductor	234,750,023	1 17	274,657,527	84,443,411	98,481,711	176,175,816	31 86	5,529,687	2 36%
368 0	Line Transformers	406,858,746	1 10	447,544,621	84,069,351	98,045,465	349,499,156	35 73	9,781,672	2 40%
369 0	Services	96,876,860	1 74	168,565,736	39,645,877	46,236,808	122,328,928	45 12	2,711,191	2 80%
370 0	Meters	85,774,920	1 26	108,076,399	29,069,147	33,901,749	74,174,650	10 97	6,761,591	7 88%
371 0	Installations on Custs Prem	44,016,257	1 31	57,661,297	15,550,478	18,135,668	39,525,629	18 26	2,164,602	4 92%
373 0	Street Lighting & Signal Sys	<u>42,798,295</u>	1 34	<u>57,349,715</u>	<u>13,128,934</u>	<u>15,311,554</u>	<u>42,038,161</u>	30 84	<u>1,363,105</u>	3 18%
Total Distribution Plant		2,271,709,069	1.33	3,019,067,076	697,693,066	813,681,091	2,205,385,985	34.69	63,573,769	2.80%
GENERAL PLANT										
390 0	Structures & Improvements	106,506,342	1 05	111,831,659	22,239,734	19,706,068	92,125,591	46 47	1,982,475	1 86%
391 0	Office Furniture & Equipment	9,282,784	1 00	9,282,784	6,732,506	5,965,503	3,317,281	8 24	402,583	4 34%
391 1	Office Equipment - Computers	45,523	1 00	45,523	26,378	23,373	22,150	2 94	7,534	16 55%
392 0	Transportation Equipment	4,118,518	0 97	3,994,962	2,011,311	1,782,172	2,212,790	9 93	222,839	5 41%
393 0	Stores Equipment	3,121,778	1 02	3,184,214	1,803,020	1,597,610	1,586,604	13 01	121,953	3 91%
394 0	Tools Shop & Garage Equipment	28,793,058	1 01	29,080,989	9,861,980	8,738,451	20,342,538	23 13	879,487	3 05%
395 0	Laboratory Equipment	5,501,275	1 02	5,611,301	3,968,861	3,516,707	2,094,594	10 24	204,550	3 72%
396 0	Power Operated Equipment	698,227	0 98	684,262	306,662	271,725	412,537	11 04	37,368	5 35%
397 0	Communication Equipment	43,330,733	1 00	43,330,733	15,292,362	13,550,176	29,780,557	12 94	2,301,434	5 31%
398 0	Miscellaneous Equipment	2,423,516	1 00	2,423,516	1,147,012	1,016,338	1,407,178	10 53	133,635	5 51%
399 3	Alliance Rail	<u>5,872,017</u>	1 00	<u>5,872,017</u>	<u>2,888,289</u>	<u>2,559,240</u>	<u>3,312,777</u>	22 50	<u>147,235</u>	2 51%
Total General Plant		209,693,771	1 03	215,341,960	66,278,115	58,727,363	156,614,597	24 31	6,441,093	3.07%
Total Depreciable Plant		<u>8,814,223,142</u>	1 20	<u>10,533,567,820</u>	<u>2,625,708,713</u>	<u>2,611,566,345</u>	<u>7,922,001,475</u>	33.89	<u>233,783,288</u>	2.65%

Notes:

- (1) Steam Production Plant original cost and accumulated depreciation were adjusted for the May 2020 retirements of Knox Lee Units 2 & 3, Lieberman Unit 2 and the Lone Star Plant.
- (2) The terminal net salvage cost associated to the Lone Star Plant is included with the terminal net salvage cost of the Lieberman Plant.
- (3) No costs associated with the Dolet Hills Power Station are included in this depreciation study.

SOUTHWESTERN ELECTRIC POWER COMPANY
ANNUAL DEPRECIATION RATES AND ACCRUALS BY THE REMAINING LIFE METHOD
SCHEDULE II - COMPARE DEPRECIATION EXPENSE USING CURRENT AND STUDY RATES
BASED ON PLANT IN SERVICE AT DECEMBER 31, 2019

No (1)	Title (2)	Original Cost (3)	Current Approved Rate (4)	Annual Accrual (5)	Study Rate (6)	Study Accrual (7)	Difference (Decrease) (8)
STEAM PRODUCTION PLANT (1)							
Gas & Oil Plants							
ARSENAL HILL							
311 0	Structures & Improvements	6,523,578	4 59%	299,432	5 53%	360,589	61,157
312 0	Boiler Plant Equipment	7,190,747	5 02%	360,975	5 84%	419,809	58,834
314 0	Turbogenerator Units	5,437,070	4 37%	237,600	5 29%	287,582	49,982
315 0	Accessory Electrical Equipment	1,250,953	5 44%	68,052	6 32%	79,075	11,023
316 0	Misc Power Plant Equip	<u>7,211,222</u>	6 88%	<u>496,132</u>	8 46%	<u>610,322</u>	<u>114,190</u>
	Total	<u>27,613,570</u>	5 30%	<u>1,462,191</u>	6 36%	<u>1,757,377</u>	<u>295,186</u>
KNOX LEE							
311 0	Structures & Improvements	9,069,087	3 49%	316,511	3 28%	297,836	-18,675
312 0	Boiler Plant Equipment	30,014,534	3 92%	1,176,570	3 73%	1,120,248	-56,322
314 0	Turbogenerator Units	15,603,354	3 62%	564,841	3 62%	564,697	-144
315 0	Accessory Electrical Equipment	4,663,877	4 21%	196,349	4 03%	187,998	-8,351
316 0	Misc Power Plant Equip	<u>2,008,192</u>	4 99%	<u>100,209</u>	4 55%	<u>91,277</u>	<u>-8,932</u>
	Total	<u>61,359,044</u>	3 84%	<u>2,354,480</u>	3 69%	<u>2,262,056</u>	<u>-92,424</u>
LIEBERMAN (2)							
311 0	Structures & Improvements	5,407,423	4 98%	269,290	7 76%	419,717	150,427
312 0	Boiler Plant Equipment	19,379,730	5 55%	1,075,575	8 19%	1,587,750	512,175
314 0	Turbogenerator Units	10,770,201	5 13%	552,834	7 54%	812,473	259,639
315 0	Accessory Electrical Equipment	3,471,047	5 49%	190,560	8 22%	285,198	94,638
316 0	Misc Power Plant Equip	<u>2,320,380</u>	8 28%	<u>192,127</u>	11 37%	<u>263,938</u>	<u>71,811</u>
	Total	<u>41,348,781</u>	5 52%	<u>2,280,386</u>	8 15%	<u>3,369,076</u>	<u>1,088,690</u>
STALL							
311 0	Structures & Improvements	54,049,867	2 62%	1,416,107	2 70%	1,460,357	44,250
312 0	Boiler Plant Equipment	86,638,497	2 62%	2,269,929	2 70%	2,340,390	70,461
314 0	Turbogenerator Units	167,305,849	2 64%	4,416,874	2 75%	4,604,652	187,778
315 0	Accessory Electrical Equipment	39,669,289	2 62%	1,039,335	2 69%	1,065,214	25,879
316 0	Misc Power Plant Equip	<u>83,804,940</u>	2 62%	<u>2,195,689</u>	2 69%	<u>2,253,488</u>	<u>57,799</u>
	Total	<u>431,468,442</u>	2 63%	<u>11,337,934</u>	2 72%	<u>11,724,101</u>	<u>386,167</u>
WILKES							
311 0	Structures & Improvements	8,345,659	2 89%	241,190	2 89%	241,584	394
312 0	Boiler Plant Equipment	53,895,276	3 20%	1,724,649	3 58%	1,931,657	207,008
314 0	Turbogenerator Units	37,889,001	3 23%	1,223,815	3 22%	1,219,666	-4,149
315 0	Accessory Electrical Equipment	10,316,197	4 05%	417,806	4 11%	423,661	5,855
316 0	Misc Power Plant Equip	<u>9,145,772</u>	4 79%	<u>438,082</u>	4 76%	<u>435,216</u>	<u>-2,866</u>
	Total	<u>119,591,905</u>	3 38%	<u>4,045,542</u>	3 56%	<u>4,251,784</u>	<u>206,242</u>
	Total Gas & Oil Plants	<u>681,381,742</u>	3.15%	<u>21,480,533</u>	3.43%	<u>23,364,394</u>	<u>1,883,861</u>

SOUTHWESTERN ELECTRIC POWER COMPANY
ANNUAL DEPRECIATION RATES AND ACCRUALS BY THE REMAINING LIFE METHOD
SCHEDULE II - COMPARE DEPRECIATION EXPENSE USING CURRENT AND STUDY RATES
BASED ON PLANT IN SERVICE AT DECEMBER 31, 2019

No (1)	Title (2)	Original Cost (3)	Current Approved Rate (4)	Annual Accrual (5)	Study Rate (6)	Study Accrual (7)	Difference (Decrease) (8)
Coal and Lignite Plants							
FLINT CREEK							
311 0	Structures & Improvements	27,330,924	2 73%	746,134	2 83%	774,569	28,435
312 0	Boiler Plant Equipment	295,403,376	2 79%	8,241,754	4 16%	12,285,271	4,043,517
314 0	Turbogenerator Units	15,318,616	2 66%	407,475	2 97%	455,250	47,775
315 0	Accessory Electrical Equipment	10,970,647	2 82%	309,372	3 30%	362,430	53,058
316 0	Misc Power Plant Equip	<u>8,258,411</u>	3 00%	<u>187,752</u>	3 13%	<u>195,646</u>	<u>7,894</u>
	Total	<u>355,281,974</u>	2 78%	<u>9,892,487</u>	3 96%	<u>14,073,166</u>	<u>4,180,679</u>
PIRKEY							
311 0	Structures & Improvements	109,344,557	2 26%	2,471,187	2 19%	2,399,778	-71,409
312 0	Boiler Plant Equipment	379,562,731	2 49%	9,451,112	2 49%	9,464,375	13,263
314 0	Turbogenerator Units	50,950,757	2 27%	1,156,582	2 19%	1,118,345	-38,237
315 0	Accessory Electrical Equipment	18,401,272	2 39%	439,790	2 41%	443,142	3,352
316 0	Misc Power Plant Equip	<u>19,401,615</u>	2 37%	<u>459,818</u>	2 39%	<u>464,173</u>	<u>4,355</u>
	Total	<u>577,660,932</u>	2 42%	<u>13,978,489</u>	2 40%	<u>13,889,813</u>	<u>-88,676</u>
TURK							
311 0	Structures & Improvements	287,492,517	1 91%	5,491,107	1 91%	5,498,192	7,085
312 0	Boiler Plant Equipment	992,441,092	1 90%	18,856,381	1 91%	18,921,076	64,695
314 0	Turbogenerator Units	232,629,873	1 90%	4,419,968	1 90%	4,427,930	7,962
315 0	Accessory Electrical Equipment	93,354,798	1 90%	1,773,741	1 90%	1,777,986	4,245
316 0	Misc Power Plant Equip.	<u>48,553,150</u>	1 90%	<u>922,510</u>	1 91%	<u>925,675</u>	<u>3,165</u>
	Total	<u>1,654,471,430</u>	1 90%	<u>31,463,707</u>	1 91%	<u>31,550,859</u>	<u>87,152</u>
WELSH							
311 0	Structures & Improvements	72,936,301	2 12%	1,546,250	2 77%	2,021,902	475,652
312 0	Boiler Plant Equipment	583,599,604	2 22%	12,955,911	3 52%	20,565,023	7,609,112
314 0	Turbogenerator Units	142,048,909	2 21%	3,139,281	3 13%	4,452,215	1,312,934
315 0	Accessory Electrical Equipment	47,084,699	2 60%	1,224,202	3 52%	1,659,559	435,357
316 0	Misc Power Plant Equip	<u>21,423,993</u>	2 88%	<u>617,011</u>	3 17%	<u>679,486</u>	<u>62,475</u>
	Total	<u>867,093,506</u>	2 25%	<u>19,482,655</u>	3 39%	<u>29,378,185</u>	<u>9,895,530</u>
	Total Coal and Lignite Plants	<u>3,454,507,842</u>	2 17%	<u>74,817,338</u>	2 57% 4 04%	<u>88,892,023</u>	<u>14,074,685</u>
RAIL CARS							
312 11	Rail Cars - Flint Creek	3,989,549	3 02%	120,484	3 12%	124,555	4,071
312 11	Rail Cars - Welsh Plant	<u>12,114,203</u>	2 77%	<u>335,563</u>	2 75%	<u>332,995</u>	<u>-2,568</u>
	Total	<u>16,103,752</u>	2 83%	<u>456,047</u>	2 84%	<u>457,550</u>	<u>1,503</u>
	Total Steam Production Plant	<u>4,151,993,336</u>	2 33%	<u>96,753,918</u>	2 71%	<u>112,713,967</u>	<u>15,960,049</u>
Other Production Plant							
MATTISON							
341 0	Structures & Improvements	30,793,285	2 49%	618,605	2 53%	780,152	161,547
344 0	Generators	84,008,692	2 49%	1,299,076	2 53%	2,126,890	827,814
345 0	Accessory Electrical Equip	8,998,287	2 52%	616,169	2 60%	233,926	-382,243
346	Misc Power Plant Equip	<u>829,903</u>	2 68%	<u>226,055</u>	2 74%	<u>22,764</u>	<u>-203,291</u>
	Total	<u>124,630,167</u>	2 21%	<u>2,759,905</u>	2 54%	<u>3,163,732</u>	<u>403,827</u>
	Total Other Production Plant	<u>124,630,167</u>	2 21%	<u>2,759,905</u>	2 54%	<u>3,163,732</u>	<u>403,827</u>
	Total Production Plant	<u>4,276,623,503</u>	2 33%	<u>99,513,823</u>	2 71%	<u>115,877,699</u>	<u>16,363,876</u>

SOUTHWESTERN ELECTRIC POWER COMPANY
ANNUAL DEPRECIATION RATES AND ACCRUALS BY THE REMAINING LIFE METHOD
SCHEDULE II - COMPARE DEPRECIATION EXPENSE USING CURRENT AND STUDY RATES
BASED ON PLANT IN SERVICE AT DECEMBER 31, 2019

No (1)	Title (2)	Original Cost (3)	Current Approved Rate (4)	Annual Accrual (5)	Study Rate (6)	Study Accrual (7)	Difference (Decrease) (8)
TRANSMISSION PLANT							
350 1	Land Rights	98,424,907	1 29%	1,269,681	1 33%	1,309,421	39,740
352 0	Structures & Improvements	25,073,646	1 32%	330,972	1 46%	366,151	35,179
353 0	Station Equipment	702,710,223	1 27%	8,924,420	1 54%	10,795,690	1,871,270
354 0	Towers & Fixtures	40,325,282	1 40%	564,554	1 46%	588,741	24,187
355 0	Poles & Fixtures	759,166,339	3 10%	23,534,157	3 42%	25,929,483	2,395,326
356 0	OH Conductor & Devices	426,450,498	1 78%	7,590,819	2 07%	8,821,574	1,230,755
357 0	Underground Conduit	3,826,324	1 78%	68,109	1 99%	76,143	8,034
358 0	Underground Conductor & Devices	87,633	1 69%	1,481	1 99%	1,742	261
359 0	Roads and Trails	<u>131,947</u>	1 35%	<u>1,781</u>	1 35%	<u>1,782</u>	<u>1</u>
Total Transmission Plant		<u>2,056,196,799</u>	2 06%	<u>42,285,974</u>	2 33%	<u>47,890,727</u>	<u>5,604,753</u>
DISTRIBUTION PLANT							
360 1	Land Rights	3,593,142	0 99%	35,572	1 41%	50,489	14,917
361 0	Structures & Improvements	9,551,154	1 27%	121,300	1 43%	136,646	15,346
362 0	Station Equipment	331,732,959	1 91%	6,336,100	1 95%	6,468,354	132,254
364 0	Poles, Towers, & Fixtures	470,031,668	2 49%	11,703,789	2 83%	13,284,509	1,580,720
365 0	Overhead Conductor & Devices	474,074,113	2 69%	12,752,594	3 03%	14,343,412	1,590,818
366 0	Underground Conduit	71,650,932	1 25%	895,637	1 37%	978,511	82,874
367 0	Underground Conductor	234,750,023	1 72%	4,037,700	2 36%	5,529,687	1,491,987
368 0	Line Transformers	406,858,746	1 90%	7,730,316	2 40%	9,781,672	2,051,356
369 0	Services	96,876,860	2 71%	2,625,363	2 80%	2,711,191	85,828
370 0	Meters	85,774,920	4 06%	3,482,462	7 88%	6,761,591	3,279,129
371 0	Installations on Custs Prem	44,016,257	4 38%	1,927,912	4 92%	2,164,602	236,690
373 0	Street Lighting & Signal Sys	<u>42,798,295</u>	3 02%	<u>1,292,509</u>	3 18%	<u>1,363,105</u>	<u>70,596</u>
Total Distribution Plant		<u>2,271,709,069</u>	2 33%	<u>52,941,254</u>	2 80%	<u>63,573,769</u>	<u>10,632,515</u>
GENERAL PLANT							
390 0	Structures & Improvements	106,506,342	1 62%	1,725,403	1 86%	1,982,475	257,072
391 0	Office Furniture & Equipment	9,282,784	4 32%	401,016	4 34%	402,583	1,567
391 1	Office Equipment - Computers	45,523	10 69%	4,866	16 55%	7,534	2,668
392 0	Transportation Equipment	4,118,518	1 82%	74,957	5 41%	222,839	147,882
393 0	Stores Equipment	3,121,778	3 94%	122,998	3 91%	121,953	-1,045
394 0	Tools Shop & Garage Equipment	28,793,058	3 08%	886,826	3 05%	879,487	-7,339
395 0	Laboratory Equipment	5,501,275	1 52%	83,619	3 72%	204,550	120,931
396 0	Power Operated Equipment	698,227	5 53%	38,612	5 35%	37,368	-1,244
397 0	Communication Equipment	43,330,733	8 79%	3,808,771	5 31%	2,301,434	-1,507,337
398 0	Miscellaneous Equipment	2,423,516	6 32%	153,166	5 51%	133,635	-19,531
399 3	Alliance Rail	<u>5,872,017</u>	1 41%	<u>82,795</u>	2 51%	<u>147,235</u>	<u>64,440</u>
Total General Plant		<u>209,693,771</u>	3 52%	<u>7,383,029</u>	3 07%	<u>6,441,093</u>	<u>-941,936</u>
Total Depreciable Plant		<u>8,814,223,142</u>	2 29%	<u>202,124,080</u>	2 65%	<u>233,783,288</u>	<u>31,659,208</u>

Notes:

- (1) Steam Production Plant original cost and accumulated depreciation were adjusted for the May 2020 retirements of Knox Lee Units 2 & 3, Lieberman Unit 2 and the Lone Star Plant.
(2) The terminal net salvage cost associated to the Lone Star Plant is included with the terminal net salvage cost of the Lieberman Plant
(3) No costs associated with the Dolet Hills Power Station are included in this depreciation study.

**SOUTHWESTERN ELECTRIC POWER COMPANY
SCHEDULE III - COMPARISON OF MORTALITY CHARACTERISTICS
DEPRECIATION STUDY AS OF DECEMBER 31, 2019**

<u>TX</u>	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
		Existing Rates					Current Study Rates				
		Average		Cost of	Net		Average		Cost of	Net	
		Service	Iowa	Salvage	Removal	Salvage	Service	Iowa	Salvage	Removal	Salvage
		Life	Curve	Factor	Factor	Factor	Life	Curve	Factor	Factor	Factor
		(Years)					(Years)				
<u>TRANSMISSION PLANT</u>											
350.1	Rights of Way	70	R5.0	0%	0%	0%	70	R5.0	0%	0%	0%
352.0	Structures & Improvements	65	S5.0	3%	8%	-5%	70	R3.5	0%	7%	-7%
353.0	Station Equipment	73	R1.5	8%	18%	-10%	68	S0.0	5%	14%	-9%
354.0	Towers & Fixtures	60	L3.0	1%	15%	-14%	65	L3.0	2%	20%	-18%
355.0	Poles & Fixtures	50	S0.5	1%	66%	-65%	46	S0.5	3%	67%	-64%
356.0	Overhead Conductor & Devices	70	R2.5	13%	55%	-42%	70	R2.0	9%	62%	-53%
357.0	Underground Conduit	50	R1.5	0%	0%	0%	50	R1.5	0%	0%	0%
358.0	Underground Conductor and Devices	50	R1.5	0%	0%	0%	50	R1.5	0%	0%	0%
359.0	Roads and Trails	65	R4.0	0%	0%	0%	65	R4.0	0%	0%	0%
<u>DISTRIBUTION PLANT</u>											
360.1	Rights of Way	60	R4.0	0%	0%	0%	60	R4.0	0%	0%	0%
361.0	Structures & Improvements	70	R3.0	0%	11%	-11%	75	R3.0	0%	11%	-11%
362.0	Station Equipment	55	S0.5	5%	21%	-16%	57	S0.5	6%	22%	-16%
364.0	Poles, Towers, & Fixtures	55	R0.5	15%	69%	-54%	55	S0.5	12%	76%	-64%
365.0	Overhead Conductor & Devices	44	R1.0	6%	44%	-38%	44	R1.0	5%	45%	-40%
366.0	Underground Conduit	70	R4.0	0%	0%	0%	70	R4.0	0%	0%	0%
367.0	Underground Conductor	50	R1.5	6%	22%	-16%	46	R3.0	4%	21%	-17%
368.0	Line Transformers	50	L0.0	9%	15%	-6%	44	L0.0	9%	19%	-10%
369.0	Services	55	R2.5	0%	74%	-74%	59	R3.0	0%	74%	-74%
370.0	Meters	30	R1.0	9%	44%	-35%	15	L0.0	6%	32%	-26%
371.0	Installations on Custs. Prem.	25	L0.0	8%	41%	-33%	25	L0.0	6%	37%	-31%
373.0	Street Lighting & Signal Sys	37	L0.0	10%	42%	-32%	40	L0.0	7%	41%	-34%
<u>GENERAL PLANT</u>											
390.0	Structures & Improvements	55	L0.5	9%	12%	-3%	58	L0.0	5%	10%	-5%
391.0	Office Furniture & Equipment	30	SQ	2%	1%	1%	30	SQ	0%	0%	0%
391.1	Computers	7	SQ	0%	0%	0%	7	SQ	0%	0%	0%
392.0	Transportation Equipment	20	SQ	8%	0%	8%	20	SQ	3%	0%	3%
393.0	Stores Equipment	30	SQ	2%	4%	-2%	30	SQ	1%	3%	-2%
394.0	Tools Shop & Garage Equipment	35	SQ	0%	1%	-1%	35	SQ	0%	1%	-1%
395.0	Laboratory Equipment	35	SQ	0%	2%	-2%	35	SQ	0%	2%	-2%
396.0	Power Operated Equipment	20	SQ	2%	0%	2%	20	SQ	2%	0%	2%
397.0	Communication Equipment	20	SQ	2%	0%	2%	20	SQ	0%	0%	0%
398.0	Miscellaneous Equipment	20	SQ	1%	0%	1%	20	SQ	0%	0%	0%

**SOUTHWESTERN ELECTRIC POWER COMPANY
SCHEDULE IV - Generating Unit Retirement Dates
December 31, 2019**

Station & Unit	Capability MW	Year Installed	Estimated Year Retired	Life Span (Years)
<u>GAS & OIL UNITS</u>				
Arsenal Hill				
Unit 5	110	1960	2025	65
Knox Lee				
Unit 5	342	1974	2039	65
Lieberman				
Unit 3	109	1957	2022	65
Unit 4	108	1959	2024	65
Mattison				
Unit 1	76	2007	2052	45
Unit 2	76	2007	2052	45
Unit 3	76	2007	2052	45
Unit 4	76	2007	2052	45
Stall				
Unit 6	500	2010	2050	40
Wilkes				
Unit 1	177	1964	2029	65
Unit 2	362	1970	2035	65
Unit 3	362	1971	2036	65
<u>COAL & LIGNITE UNITS</u>				
Dolet Hills (1)				
Unit 1	262	1986	2021	35
Flint Creek				
Unit 1	264	1978	2038	60
Pirkey				
Unit 1	580	1985	2045	60
Turk				
Unit 1	440	2012	2067	55
Welsh				
Unit 1	528	1977	2037	60
Unit 3	528	1982	2042	60

Notes:

(1) The recovery of the Dolet Hills Power Station is being addressed outside of the depreciation study.

EXECUTIVE SUMMARY OF DAVID A. HODGSON

David A. Hodgson, Tax Accounting & Regulatory Support Manager for American Electric Power Service Corporation, presents the tax schedules and tax amounts included in the cost of service and rate base for Southwestern Electric Power Company (SWEPCO) for the test year. In his testimony, Mr. Hodgson specifically discusses:

- Normalization;
- Federal Income Taxes included in cost of service;
- Tax Schedules provided in the Rate Filing Package (RFP); and
- Pro forma Adjustments.

Mr. Hodgson explains normalized income tax accounting in the context of a public utility. He testifies that normalization is a method of accounting in which the tax benefits of accelerated depreciation on public utility assets are passed to customers ratably over the regulatory useful life of the assets in the form of reduced rates. Mr. Hodgson describes the impact of normalization rules on the Company's Accumulated Deferred Federal Income Tax (ADFIT) balance, Net Operating Loss Carryforward (NOLC), and Investment Tax Credits (ITC) for the test year. He further explains the applicable law and IRS guidance on normalization in regulatory ratemaking and the tax consequences of non-compliance with normalization requirements.

Mr. Hodgson testifies that the federal income tax expense included in SWEPCO's cost of service has been calculated using the "return" method for the historical year, as required by the Instructions and Schedules to the RFP. This return method calculation reflects a "stand-alone" approach that includes in the cost of service only, federal income taxes that result from the provision of utility service to customers. Mr. Hodgson demonstrates that it is neither appropriate nor equitable to increase or reduce the cost of service by tax costs or benefits that are not related to the rendition of utility service to customers. Use of the return method also satisfies the

requirements of PURA §§ 36.059 and 36.060. In SWEPCO's filing, requested tax expense is based solely on the income, expenses, and investments used in determining SWEPCO's revenue requirement.

Mr. Hodgson presents testimony regarding the impact of the Tax Cut and Jobs Act of 2017 (TCJA) and its impact on the Company and customers. He specifically explains the Excess ADFIT created by the TCJA and how the Company intends to return the Excess ADFIT to customers, both the protected (normalized) and unprotected (offset to unrecovered costs).

Mr. Hodgson demonstrates that the federal income tax schedules that are part of SWEPCO's filing are in compliance with the prescribed RFP and are in accordance with the Substantive Rules of this Commission. He also explains the four types of pro forma adjustments included in the calculation of federal income tax expense: 1) adjustments to include the tax effects of other adjustments to cost of service; 2) adjustments to remove any income tax expense recorded in the historical test year that was related to periods outside the test year; 3) an adjustment to synchronize the deduction of interest for federal income tax purposes; and 4) adjustments to tax amortizations to reflect a pro forma level of amortization of ITC and EDFIT.

Finally, Mr. Hodgson describes adjustments to the ADFIT balance as of the end of the test year, including the following: 1) adjustments to ADFIT related to pro forma adjustments to other rate base items; 2) adjustments made for ratemaking purposes, such as removing ADFIT that does not relate to the Texas jurisdiction and reducing ADFIT by the NOLC balance; and 3) adjustments made to ADFIT related to balances that are not related to electric service.

PUBLIC UTILITY COMMISSION OF TEXAS

APPLICATION OF
SOUTHWESTERN ELECTRIC POWER COMPANY
FOR AUTHORITY TO CHANGE RATES

DIRECT TESTIMONY OF
DAVID A. HODGSON
FOR
SOUTHWESTERN ELECTRIC POWER COMPANY

OCTOBER 2020

TESTIMONY INDEX

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EXHIBITS

<u>EXHIBIT</u>	<u>DESCRIPTION</u>
EXHIBIT DAH-1	IRS Private Letter Ruling 201436037
EXHIBIT DAH-2	IRS Private Letter Ruling 201438003
EXHIBIT DAH-3	IRS Private Letter Ruling 201519021
EXHIBIT DAH-4	IRS Private Letter Ruling 201534001
EXHIBIT DAH-5	IRS Private Letter Ruling 201548017
EXHIBIT DAH-6	IRS Private Letter Ruling 201709008
EXHIBIT DAH-7	IRS Private Letter Ruling 202010002
EXHIBIT DAH-8	Journal Entries Associated with Pro Forma NOL Adjustment (Highly Sensitive)

1 I. INTRODUCTION

2 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

3 A. My name is David A. Hodgson. My business address is American Electric Power, 1
4 Riverside Plaza, Columbus, Ohio 43215.

5 Q. PLEASE INDICATE BY WHOM YOU ARE EMPLOYED AND IN WHAT
6 CAPACITY.

7 A. I am a Tax Accounting & Regulatory Support Manager for American Electric Power
8 Service Corporation (AEPSC), a wholly owned subsidiary of American Electric Power
9 Company, Inc. (AEP).

10 Q. PLEASE BRIEFLY DESCRIBE YOUR EDUCATIONAL BACKGROUND AND
11 BUSINESS EXPERIENCE.

12 A. I graduated from The Ohio State University with a Bachelor of Science in Business
13 Administration in Accounting. In 2000, I accepted a position with AEPSC as a Tax
14 Analyst V. I was promoted to positions from Tax Analyst IV to Tax Analyst I over the
15 course of 2002–2009. In 2011, I was promoted to Sr. Tax Analyst and later that year
16 to Tax Project Manager and in 2013 to Tax Manager. I was promoted to my current
17 position in 2019. As Tax Accounting & Regulatory Support Manager, I participate in
18 the recording of the tax accounting entries and records and the review of federal and
19 state tax returns of AEP and its subsidiaries. I am also responsible for coordinating and
20 developing state and federal tax data provided by the AEPSC Tax Department for use
21 in regulatory proceedings. I have attended numerous tax, accounting, and regulatory
22 seminars throughout my professional career.

1 II. PURPOSE OF TESTIMONY

2 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

3 A. The purpose of my testimony is to present and sponsor the G-7 tax schedules included
4 in the Rate Filing Package (RFP) and federal income tax amounts included in the cost
5 of service and rate base for the Company for the historical test year. I will specifically
6 discuss:

- 7 • Federal Income Taxes included in cost of service;
8 • Tax Schedules provided in the Rate Filing Package (RFP); and
9 • Proforma Adjustments.

10 Q. WHAT IS THE AMOUNT OF FEDERAL INCOME TAX EXPENSE THE
11 COMPANY IS REQUESTING TO BE INCLUDED IN RATES?

12 A. The Company is requesting the amount of federal income tax expense that is included
13 in the cost of service reflected on Schedule G-7.

14 Q. WHAT IS THE TEST YEAR FOR WHICH THE TAX SCHEDULES ARE
15 PROVIDED?

16 A. Amounts in the schedules are shown for the historical test year with adjustments, for
17 the 12-month period ended March 31, 2020.

18 Q. WHAT IS THE SOURCE OF INFORMATION USED FOR THE PREPARATION
19 OF THE TAX SCHEDULES INCLUDED IN THIS RATE FILING?

20 A. All amounts included in the tax schedules for this rate filing are taken from the books
21 and records of the Company.

1 III. SCHEDULES SPONSORED

2 Q. PLEASE LIST THE SCHEDULES THAT YOU ARE SPONSORING AND
3 PROVIDE A BRIEF SUMMARY OF EACH.

4 A. I sponsor the following schedules:

- 5 • Schedule G-7: This schedule shows the calculation of federal income taxes using
6 the “return” method for the test year by function. This schedule represents what is
7 known as the Method 1 calculation of test year federal income tax expense. This
8 schedule starts with the return on rate base and adjusts this return by subtracting
9 interest synchronization, investment tax credit (ITC) amortization, excess deferred
10 federal income taxes (EDFIT) amortization and other permanent deductions. Flow-
11 through depreciation and non-deductible expenses are then added to the return
12 amount to arrive at the taxable component of return. This taxable component of
13 return is multiplied by the applicable tax factor (tax rate divided by 1 minus the tax
14 rate) to arrive at federal income taxes before adjustments. This federal income tax
15 amount is then adjusted for applicable ITC amortization, EDFIT amortization, and
16 other credits to arrive at total federal income tax expense.
- 17 • Schedule G-7.1: This schedule is the reconciliation of book net income to taxable
18 net income for the test year and for the most recent year for which a federal income
19 tax return was filed. The workpapers for Schedule G-7.1 contain explanations of
20 all items in the reconciliation for both the test year and the tax return.
- 21 • Schedule G-7.1a: This schedule includes a listing of timing differences and other
22 items that produce federal income tax at a tax rate different than the statutory 21%
23 tax rate, with explanations describing each item.
- 24 • Schedule G-7.2: This schedule provides the tax basis, tax in-service date, tax
25 depreciation methods, tax depreciation in the test year and projected for the two
26 subsequent years, and amount of Accumulated Deferred Federal Income Tax
27 (ADFIT) as of the test year end for all generation plants purchased or constructed
28 since the Company’s last rate case. This schedule is not applicable for this filing
29 as the Company has not purchased or constructed any generation plants since the
30 last rate case.
- 31 • Schedule G-7.3 (HS) (all): These schedules are not applicable to SWEPCO. In the
32 2013 Regular Session, Senate Bill 1364 repealed the language in Public Regulatory
33 Act § 36.060 regarding the consolidated tax savings adjustment. The 2018 federal
34 income tax consolidated return, which was filed in October 2019 is included as part
35 of the RFP as a workpaper to Schedule G-7.13 and is treated as highly sensitive,
36 protected material.
- 37 • Schedule G-7.4: This schedule shows the balance sheet amount of ADFIT for the
38 twelve months of the test year; at the end of the test year; and the additions and

- 1 reductions for the test year, as well as the requested adjustments to the balances.
2 Each item that gives rise to ADFIT is shown separately on this schedule.
- 3 • Schedule G-7.4a: This schedule describes the nature of each timing difference
4 listed in Schedule G-7.4 that gives rise to an ADFIT deferral.
 - 5 • Schedule G-7.4b: This schedule shows the details of the adjustments to the balance
6 sheet ADFIT accounts. The reasons for these adjustments are included as well as
7 the supporting calculations, if any.
 - 8 • Schedule G-7.4c: This schedule provides the ADFIT and Accumulated Deferred
9 Investment Tax Credit (ADITC) at test year-end related to additions to generating
10 plant in service since the Company's last rate filing. This generation plant addition
11 information is provided on Schedule G-7.2. Neither schedule is applicable for this
12 filing as the Company has not purchased or constructed any generation plants since
13 the last rate case.
 - 14 • Schedule G-7.4d: This schedule provides the ADFIT associated with rate case
15 expense from prior proceedings.
 - 16 • Schedule G-7.5: This schedule presents the analysis of the ITC adjustment for
17 Deferred Investment Tax Credit (DITC) to be included in cost of service. The
18 "stripped" book depreciation rate requested is derived from the book depreciation
19 calculation. This rate represents the life or investment portion of the book
20 depreciation rate without regard to amounts for cost of removal or salvage. The
21 stripped depreciation rate is multiplied by the ITC amortization base to calculate
22 the annual amount of DITC amortization that is included in cost of service. This
23 DITC amortization is included in cost of service as a reduction of tax expense. The
24 stripped depreciation rate is used in this computation to avoid a potential
25 normalization violation that could result if the ITCs were amortized in cost of
26 service at a rate more rapid than ratably. As described later, Section 46(f)(2) of the
27 Internal Revenue Code (the Code) requires that these credits be amortized in cost
28 of service no more rapidly than ratably.
 - 29 • Schedule G-7.5a: This schedule is a summary of all ITC utilized by the Company
30 for tax return purposes. The schedule shows the ITC by year adjusted for ITC
31 recapture. The totals from this schedule support the ITC amortization base found
32 on G-7.5.
 - 33 • Schedule G-7.5b: This schedule presents ITCs that have been generated but not
34 utilized by the Company. All ITC that has been generated has been utilized.
 - 35 • Schedule G-7.5c: This schedule shows ITC utilized by the Company as if it had
36 filed its tax return on a separate return basis taking into account the limitations
37 included in the Code based on the separate return methodology.
 - 38 • Schedule G-7.5d: This schedule indicates the tax elections made by Southwestern
39 Electric Power Company (SWEPCO) with regard to ITC. There have not been any
40 new ITC elections made since Docket No. 46449. In 1971, SWEPCO made the
41 Section 46(f)(2) election concerning treatment of ITC for ratemaking purposes.

1 This Code section requires that these credits be amortized in the cost of service no
2 more rapidly than ratably, with no rate base reduction. The Pre-1971 ITC utilized
3 for rate purposes was not restricted by the Code and is therefore afforded both rate
4 base reduction as well as cost of service amortization. The Pre-1971 ITC has been
5 fully amortized and is not a consideration in this filing.

- 6 • Schedule G-7.5e: This schedule shows the balance of the unamortized ADITC in
7 FERC Account No. 255 – ADITCs as of March 31, 2020.
- 8 • Schedule G-7.6: This schedule calculates federal income tax expense for the test
9 year using Tax Method 2. This method of calculating federal income tax expense
10 determines the current and deferred components of federal income tax expense
11 separately. The components of federal income tax expense shown on this schedule
12 include taxes currently payable, deferred taxes, and DITC amortization. The Tax
13 Method 2 calculation of federal income tax is equal to the amount of federal income
14 tax computed under the Return Method (see Schedule G-7.8).
- 15 • Schedule G-7.6a: This schedule is an analysis of each deferred tax item that makes
16 up the deferred tax expense in Schedule G-7.6.
- 17 • Schedule G-7.7: This schedule provides the detail support for the requested
18 adjustment to return for additional depreciation. This schedule summarizes the
19 major components related to flow-through book depreciation for which there is no
20 deferred tax benefit.
- 21 • Schedule G-7.8: This schedule provides the calculation of federal income tax
22 expense using the return method. This schedule is identical to Schedule G-7,
23 Federal Income Taxes.
- 24 • Schedule G-7.9: This schedule summarizes the amortization of protected and
25 unprotected EDFIT and the amortization methodology utilized. At the time of this
26 filing, the Public Utility Commission of Texas (the Commission) has not issued an
27 order for the amortization of SWEPCO's unprotected EDFIT. As described in the
28 testimony of Company witnesses Michael Baird and Tom Brice, the Company is
29 proposing to utilize the customer benefit of the unamortized balance of EDFIT to
30 partially offset the undepreciated book cost of the Dolet Hills Power Station.
31 Therefore, no amortization of unprotected EDFIT is reflected as a benefit to tax
32 expense in the cost of service.
- 33 • Schedule G-7.9a: This schedule shows the details of the information contained in
34 Schedule G-7.9 by timing difference. This information includes the remaining
35 excess deferred tax balance at the end of the test year and the requested amortization
36 for each item.
- 37 • Schedule G-7.9b: This schedule provides the ADFIT balances and adjustments by
38 timing difference due to the tax rate change of 35% to 21% as codified by the Tax
39 Cuts and Jobs Act (TCJA). It shows the balances just prior to enactment of the rate
40 change as well as the remeasurement for the 14% rate differential and the balance
41 after adjustment. The remeasurement of each individual timing difference is offset

1 by a new excess ADFIT timing difference for a net zero impact on ADFIT and
2 maintaining rate base neutrality.

- 3 • Schedule G-7.9c: Normally this schedule would provide balances at the end of the
4 year in accounts established by the Commission for reserve accounting. The
5 Company has no such reserve accounting requirements, therefore this schedule is
6 not applicable for this filing.
- 7 • Schedule G-7.10: Normally, this schedule would list and explain all effects on
8 federal income tax and ADFIT of any Company accounting order (cost) deferrals.
9 SWEPCO has no such accounting orders, therefore this schedule is not applicable
10 for this filing.
- 11 • Schedule G-7.11: Normally, this schedule would list and explain all effects on
12 federal income tax and ADFIT of any Company post-test year adjustments. The
13 Company has no post-test year adjustments, therefore this schedule is not
14 applicable for this filing.
- 15 • Schedule G-7.12: Normally, this schedule would provide an explanation of how
16 federal income tax and ADFIT would be impacted by a rate moderation plan
17 request. The Company has not requested a rate moderation plan, therefore this
18 schedule is not applicable for this filing.
- 19 • Schedule G-7.12a: Normally, this schedule would provide an explanation of how
20 federal income tax and ADFIT are treated in any existing rate moderation plans.
21 SWEPCO does not have any existing rate moderation plans, therefore this schedule
22 is not applicable for this filing.
- 23 • Schedule G-7.13: This schedule lists all witnesses that are filing testimony in this
24 case that supports federal income tax and ADFIT. In addition, this schedule
25 indicates that the most recent tax return filed should be included as a workpaper.
26 As indicated above, the most recent tax return filed (for the year 2018) is included
27 as a workpaper to Schedule G-7.13.
- 28 • Schedule G-7.13a: This schedule details the history of tax normalization for the
29 Company and also provides details for timing items in which deferred taxes were
30 not provided, resulting in flow-through differences.
- 31 • Schedule G-7.13b: Tax elections made by SWEPCO are detailed in this schedule.
32 Certain provisions in the Code require taxpayers to include elections in returns
33 specifying the tax treatment selected by the taxpayer which may be binding on
34 future treatment of like transactions.
- 35 • Schedule G-7.13c: This schedule provides an explanation of any changes in the
36 Company's accounting for deferred federal income taxes that would have an impact
37 on regulatory ratemaking. The Company has not made any changes to its method
38 of accounting since its most recent rate filing.
- 39 • Schedule G-7.13d: This schedule explains the Company's current audit status with
40 the Internal Revenue Service. SWEPCO is currently being audited for amended

returns filed for the years 2014 through 2017. The year 2018 is open under the general statute of limitations.

- Schedule G-7.13e (HS): This schedule includes a list of Private Letter Rulings received by SWEPCO or its parent company since the Company's last rate filing.
- Schedule G-7.13f (HS): This schedule relates to the accounting for Net Operating Loss (NOL) carryforwards. It presents the taxable income and losses that have contributed to the NOLC representative of the utility operations of the Company. It also demonstrates the journal entries that the Company would use to record both the generation and utilization of NOLs.
- Schedule B-1: This schedule details the various rate base accounts and accumulated provision accounts included in rate base for the historical test year. Amounts that I sponsor on this schedule are the Total Company ADFIT balances, SFAS 109 regulatory assets and liabilities, and Pre-1971 unamortized deferred ITC. Other items on this schedule are sponsored by and discussed in the testimony of Company witness Michael Baird.

IV. ACCOUNTING FOR INCOME TAXES

Q. CAN YOU PLEASE DESCRIBE NORMALIZED INCOME TAX ACCOUNTING?

A. Accounting Standards Codification (ASC) 740 covers how companies should both account for and report taxes based on income. The two basic objectives of ASC 740 are to recognize both the amount of taxes that are either payable or refundable for the current tax year as well as to recognize the deferred tax assets and liabilities for the future tax consequences that have been recognized in a company's financial statements. The accounting for income taxes called for by ASC 740 is known as normalized income tax accounting. Normalization accounting for income taxes calculates income tax expense on the pre-tax items of income and expense recorded for financial statement purposes or included in the cost of service for ratemaking purposes. The income tax expense is then adjusted for permanent differences between income recorded for financial reporting (book) purposes and income determined for income tax reporting

1 (tax) purposes. Tax expense is then divided between the amount currently payable to
2 the IRS and the amount that must be paid in the future. This division between current
3 and deferred tax expense is calculated based on certain temporary differences between
4 book and taxable income. The tax expense incurred in the current year for which
5 payment is deferred due to temporary book/tax differences is recorded on the balance
6 sheet as an ADFIT liability or asset, whichever the case may be.

7 Q. PLEASE EXPLAIN WHAT NORMALIZATION TAX ACCOUNTING MEANS IN
8 THE CONTEXT OF A PUBLIC UTILITY COMPANY.

9 A. For a public utility company, normalization is a method of accounting in which the tax
10 benefits of accelerated depreciation on public utility assets are shared with customers
11 ratably over the regulatory useful life of the assets in the form of reduced rates.

12 Q. CAN YOU EXPLAIN FLOW-THROUGH TAX ACCOUNTING AND HOW THAT
13 DIFFERS FROM NORMALIZED TAX ACCOUNTING?

14 A. The flow-through method of tax accounting looks only at the amount of taxes that are
15 payable or refundable for the current tax year and does not recognize the future benefit
16 or detriment of temporary differences in income recorded for book purposes and
17 income determined for tax purposes. This method treats any temporary difference as a
18 permanent increase or decrease in the income taxes for the period depending on the
19 direction of the temporary difference. This method results in benefits and detriments
20 being allocated among customers in different periods depending on when a temporary
21 difference originates and reverses. For example, a timing difference that results in a
22 deduction in Year 1 would be enjoyed by the set of customers of the company in Year
23 1 as a reduction to the current year taxes payable. However, if this timing difference

1 were to reverse in Year 2, the detriment of the increase to the current year taxes payable
2 would be borne by the set of customers of the company in Year 2, which, of course, is
3 not necessarily the same set of customers as in Year 1. As the flow-through method
4 only recognizes the current tax payable or receivable and ignores the impact of future
5 tax impacts from timing differences, there is no deferred tax expense and as a result no
6 ADFIT that would be provided as a reduction to rate base.

7 Q. IN YOUR DESCRIPTION OF NORMALIZED TAX ACCOUNTING YOU
8 DISCUSS TEMPORARY DIFFERENCES, CAN YOU PLEASE EXPLAIN THIS
9 CONCEPT?

10 A. Yes. A temporary difference is a difference in the timing of recognition of an item of
11 book income and taxable income that occurs in one year and reverses in another. A
12 temporary difference does not change the overall income tax expense payable over the
13 life of the underlying timing difference, it simply impacts the timing of the payment of
14 a liability. Under the normalized tax accounting method, such temporary differences
15 do not have an impact on the overall tax expense for the period.

16 An example of a temporary difference and one that is generally the largest in
17 magnitude for a public utility company results from the use of accelerated depreciation
18 for tax purposes. While depreciation of an asset can only equal the cost of such asset
19 and can only be recognized over the life of the asset, a temporary difference can occur
20 when there are differing depreciation methods. For tax purposes accelerated tax
21 depreciation may be taken whereas for book purposes the depreciation expense
22 recognized for that same asset is calculated using the straight-line method. Over the
23 life of the asset, the same total amount of depreciation will be recognized. However,

1 under the accelerated depreciation method used for tax purposes, those deductions will
2 be recognized to a greater extent in the earlier years as compared to the straight-line
3 method. This results in taxable income that is lower in the earlier years. As the straight-
4 line depreciation begins to exceed the accelerated depreciation in the later years, it
5 results in a taxable income that is higher than book income. Over the life of the asset,
6 the amount of depreciation deducted from income for both book and tax will be the
7 same and the only impact will be the period in which the deductions are recognized.

8 Q. WHAT ARE PERMANENT DIFFERENCES AND HOW DO THEY DIFFER FROM
9 TEMPORARY DIFFERENCES?

10 A. As described in my testimony, a temporary difference results only in a change in the
11 period in which an item of income or expense is recognized for book and tax. A
12 permanent difference is an item of income or expense that will never be recognized for
13 either book income or for taxable income. These differences arise due to the different
14 rules that pertain to book accounting and the tax law. Because it is an item that will
15 never be recognized for one or the other, it results in a difference that will not reverse
16 over time as in the case of a temporary difference.

17 An example of a permanent difference is meals and entertainment expenses.
18 For book purposes, these expenses are generally recognized and reduce the overall net
19 income of the company. However, for tax purposes entertainment expenses are not
20 allowed as a deduction from income and generally only 50% of the cost of meals
21 allowed as a deduction from income. The difference between the book deduction and
22 the tax deduction for these expenses is one that will never reverse even over the course

1 of time. Therefore, tax expense must be increased by the tax on the non-deductible
2 amount of these expenses.

3 Q. WHAT IS AN NOL?

4 A. A net operating loss or NOL occurs when, in a given year, a taxpayer has more
5 deductions than taxable revenues. When an NOL occurs, the Code allows the taxpayer
6 to carry the NOL forward to subsequent years and offset otherwise taxable income
7 produced in that future year.

8 Q. ARE THERE NORMALIZATION REQUIREMENTS INCLUDED WITHIN THE
9 CODE?

10 A. Yes. The Code and accompanying treasury regulations provide normalization
11 requirements and specifically in three areas: 1) Accelerated depreciation and the
12 associated deferred tax liability (DTL) that results from its use; 2) Net Operating Loss
13 Carryforwards (NOLC) as a result of accelerated depreciation; and 3) Investment Tax
14 Credits (ITC).

15 Q. CAN YOU PLEASE DISCUSS THE NORMALIZATION REQUIREMENTS IN
16 THE CODE AS IT RELATES TO ACCELERATED DEPRECIATION?

17 A. The Code dictates that a regulated public utility must use the normalization method of
18 accounting to calculate tax expense on temporary differences associated with
19 accelerated depreciation when determining rates using a cost of service/rate of return
20 methodology. 26 U.S. Code §168(i)(9)(A) states that in order for a public utility to be
21 considered to be using a normalized method of accounting,

22 (i) the taxpayer must, in computing its tax expense for purposes of
23 establishing its cost of service for ratemaking purposes and reflecting
24 operating results in its regulated books of account, use a method of

1 depreciation with respect to such property that is the same as, and a
2 depreciation period for such property that is no shorter than, the method
3 and period used to compute its depreciation expense for such purposes,
4 and
5

6 (ii) if the amount allowable as a deduction under this section with
7 respect to such property (respecting all elections made by the taxpayer
8 under this section) differs from the amount that would be allowable as
9 a deduction under section 167 using the method (including the period,
10 first and last year convention, and salvage value) used to compute
11 regulated tax expense under clause (i), the taxpayer must make
12 adjustments to a reserve to reflect the deferral of taxes resulting from
13 such difference¹.

14 Q. CAN YOU PLEASE DISCUSS THE NORMALIZATION REQUIREMENTS AS
15 THEY RELATE TO NOLC?

16 A. This is specifically addressed in Treasury Regulation § 1.167(l)-1(h)(1)(iii), which
17 states:

18 If, however, in respect of any taxable year the use of a method of
19 depreciation other than a subsection (l) method for purposes of
20 determining the taxpayer's reasonable allowance under section 167(a)
21 results in a net operating loss carryover (as determined under section
22 172) to a year succeeding such taxable year which would not have arisen
23 (or an increase in such carryover which would not have arisen) had the
24 taxpayer determined his reasonable allowance under section 167(a)
25 using a subsection (l) method, then the amount and time of the deferral
26 of tax liability shall be taken into account in such appropriate time and
27 manner as is satisfactory to the district director.

28 Although neither the Code nor the regulations specifically address the manner in which
29 the NOL should be treated in ratemaking under the normalization rules, the IRS has
30 addressed this issue in several private letter rulings (PLRs). PLRs 201436037,
31 21438003, 201519021, 201534001, 201548017, 201709008, and 202010002² clarify

¹ 26 U.S.C. § 168(i)(9)(A).

² Included as Exhibits DAH-1 – DAH-7.

1 that a tax calculation with and without accelerated depreciation is utilized to determine
2 the amount of the NOLC ADFIT required to be normalized. To the extent that
3 accelerated depreciation creates an NOLC, the NOLC ADFIT must be a component of
4 rate base. This can be reflected in rate base through ADFIT in either one of two ways
5 to adhere to the normalization rules. In the first method, the DTL that is a result of
6 accelerated depreciation would simply be reduced by the amount of the NOLC ADFIT.
7 In the second method, the full DTL is included as a rate base reduction and a separate
8 DTA in the amount of the NOLC ADFIT is included as a rate base increase. The result
9 of both is the same in that the impact on rate base includes the net balance of the ADFIT
10 for accelerated depreciation and the ADFIT for the NOLC. The PLRs uniformly
11 conclude that excluding the NOLC ADFIT would constitute a normalization violation.

12 Q. WHAT IS THE RATIONALE FOR THIS TREATMENT OF THE NOLC ADFIT?

13 A. When a regulated utility experiences a NOLC, the taxpayer has not yet received the
14 benefit of the depreciation-related ADFIT, i.e., there is no interest free loan from the
15 federal government. Accordingly, the rate base reduction is deferred until the NOLC
16 is utilized and the loan is extended.

17 Q. PLEASE DESCRIBE THE CONCLUSIONS IN THE PLRS MENTIONED ABOVE.

18 A. The PLRs mentioned above all relate to whether NOLC ADFIT are required to be
19 included in rate base and the method which is to be used to determine the amount that
20 is required to be included. These PLRs confirm that NOLC ADFIT must be included
21 in rate base to avoid a normalization violation. They describe the NOLC as a necessary
22 reduction to the rate base impact of the DTL associated with accelerated depreciation.
23 Further, the PLRs prescribe a “with-and-without” or “last dollar deducted” approach

1 for determining the amount of the NOLC ADFIT that must be included in rate base.
2 Both of these approaches look at the hypothetical taxable income of the utility without
3 the deductions for accelerated depreciation. The extent to which a NOLC is then
4 attributable to accelerated depreciation must be included in rate base to avoid a
5 normalization violation. The PLRs all contain language very similar to the following:

6 Because the ADIT account [Account 282], the reserve account for
7 deferred taxes, reduces rate base, it is clear that the portion of an NOLC
8 that is attributable to accelerated depreciation must be taken into
9 account in calculating the amount of the reserve for deferred taxes
10 (ADIT)...

11
12 The “with or without” [or “last dollar deducted”] methodology
13 employed by Taxpayer is specifically designed to ensure that the
14 portion of the NOLC attributable to accelerated depreciation is
15 correctly taken into account by maximizing the amount of the NOLC
16 attributable to accelerated depreciation. This methodology provides
17 certainty and prevents the possibility of “flow through” of the benefits
18 of accelerated depreciation to ratepayers³

19 Q. IS THE INCLUSION OF AN NOL CARRYFORWARD IN RATE BASE ALSO A
20 SOUND ACCOUNTING AND REGULATORY PRACTICE?

21 A. Yes. The normalization treatment of an NOLC assures that the customers of a utility
22 receive the benefit of the deferred tax payment associated with accelerated depreciation
23 no sooner than they would be able to do so based on the operations of the utility as an
24 entity that files a separate return. This lines up the timing of customer benefits with
25 the ability of the utility operations to provide those benefits.

26 Q. CAN YOU PLEASE DISCUSS THE NORMALIZATION REQUIREMENTS AS
27 THEY RELATE TO ITC?

³ Bracketed entry added for clarity.

1 A. The normalization rules as they relate to ITC require that the benefit of ITC cannot be
2 passed to customers any faster than ratably over the book depreciable life of the
3 underlying assets that generated the ITC. As such, a utility is unable to provide the
4 benefits of the ITC to customers either at the time in which the credit is generated or at
5 the time in which the credit is utilized and reduces the tax liability of the utility. A
6 utility may elect to pass the benefit of ITC to customers through one of two methods
7 as directed by §46(f)(1) and §46(f)(2).

8 Under §46(f)(1), a utility passes the benefit of the ITC through a reduction to
9 rate base, provided that the reduction is restored not less rapidly than ratably. No
10 adjustment may be made to cost of service on account of the ITC. Under §46(f)(2), a
11 utility shares the benefit of the ITC with customers by amortizing the benefit in the cost
12 of service no more rapidly than ratably over the book life of the property generating
13 the credit. No reduction to rate base is permissible under this method.

14 Q. ARE THERE REPERCUSSIONS TO NOT FOLLOWING THE NORMALIZATION
15 REQUIREMENTS FOR ACCELERATED DEPRECIATION?

16 A. Yes. A depreciation-related normalization violation results in the utility no longer
17 being allowed to use accelerated depreciation on all property used to provide regulated
18 service to the jurisdiction in which the violation occurred.⁴ In addition, the taxes that
19 have been deferred as a result of the prior accelerated depreciation must be paid to the
20 federal government more quickly than they would be in the absence of the violation.

⁴ 26 U.S.C. § 168(f)(2).

1 Q. WHAT IMPACT WOULD A NORMALIZATION VIOLATION HAVE ON
2 CUSTOMERS?

3 A. A normalization violation would result in higher utility rates for customers. As noted
4 above, a normalization violation would prevent the utility from claiming deductions for
5 accelerated depreciation and would result in the company paying the IRS more rapidly
6 for the previously deferred taxes. This would result in a lower ADFIT balance which
7 would cause the rate base for the company to increase. As customers pay a return on
8 rate base, any increase in rate base would directly result in higher rates. This lower
9 ADFIT would represent the reduction to a cost-free source of capital for the company.

10 Q. WHAT IS THE PENALTY FOR AN ITC NORMALIZATION VIOLATION?

11 A. In the case of an ITC normalization violation, a utility would have to refund to the IRS
12 the balance of the unamortized ITC at the time the violation occurred. This would
13 eliminate the future benefit to customers of any reduction to rates through either a cost
14 of service or rate base reduction.

15

16 V. FEDERAL INCOME TAX CALCULATION METHOD

17 Q. WHAT TAX ACCOUNTING METHODOLOGY DESCRIBED IN YOUR
18 TESTIMONY IS USED IN THE DETERMINATION OF THE TAX EXPENSE
19 REQUESTED IN THIS CASE?

20 A. The tax expense as presented in this case is calculated using the normalized method of
21 tax accounting. The use of the normalized method is required by 16 Texas
22 Administrative Code Rule §25.231. Specifically, §25.231(b)(1)(D) describes one of
23 the components of allowable expenses as:

1 Federal income taxes on a normalized basis. Federal income taxes shall
2 be computed according to the provisions of the Public Utility
3 Regulatory Act §36.060.

4 Q. HOW HAVE FEDERAL INCOME TAXES INCLUDED IN THE COST OF
5 SERVICE BEEN CALCULATED?

6 A. Federal income taxes have been calculated using the “return” method for the historical
7 test year, as required by the Instructions and Schedules to the RFP. In addition, they
8 are calculated consistent with Generally Accepted Accounting Principles, the FERC
9 Uniform System of Accounts, the Code, including associated Treasury regulations and
10 IRS guidance, and Texas laws and precedent concerning the treatment of taxes in a
11 utility’s cost of service.

12 Q. WHAT IS THE “RETURN” METHOD?

13 A. The calculation of federal income taxes provided on Schedule G-7 is commonly
14 referred to as the “return” method because it calculates federal income taxes using after-
15 tax return as a starting point. Under this method, the equity return, or total return less
16 interest, is adjusted for items for which there is no tax deduction to offset amounts
17 recovered through revenues, such as book depreciation of permanent and flow-through
18 basis differences, preferred dividend credits, ITC amortization, the reversal of excess
19 ADFIT, and the disallowed tax deduction for business meals. The “return” method
20 calculates federal income tax expense in total with no segregation between current and
21 deferred federal income taxes. The return method tax calculation provided on Schedule
22 G-7 reflects a separate return approach to calculating federal income taxes.

1 Q. IF THE "RETURN" METHOD DOES NOT SEGREGATE BETWEEN CURRENT
2 AND DEFERRED TAX EXPENSE, HOW IS IT CONSISTENT WITH THE
3 NORMALIZED METHOD?

4 A. While the "return" method (or Method 1) does not segregate between current and
5 deferred tax expense, it does provide the correct total tax expense of the Company.
6 Schedule G-7.6 demonstrates the Method 2 approach and segregates tax expense
7 between both current and deferred and arrives at the same total tax expense. As
8 described earlier in my testimony, a temporary difference does not have an impact on
9 the overall tax expense of the Company, but rather impacts the timing of when the tax
10 is payable or receivable. Method 2 shows the amount of tax expense in the period that
11 is currently payable as well as the amount of tax expense that is being deferred and to
12 be paid at a later time. The "return" method therefore focuses on items other than
13 temporary differences which would have an impact on total tax expense such as
14 permanent differences, DITC amortization, and EDFIT amortization. The "return"
15 method provides a total tax expense consistent with normalization, but does not provide
16 the tax expense that is deferred and therefore provided as a reduction to rate base as is
17 demonstrated in the Method 2 approach.

18

19 VI. SEPARATE RETURN ACCOUNTING

20 Q. EARLIER IN YOUR TESTIMONY YOU STATED THAT THE TAXES
21 REQUESTED IN THIS CASE REPRESENT A SEPARATE RETURN APPROACH
22 TO CALCULATING FEDERAL INCOME TAXES. WHAT IS MEANT BY A
23 "SEPARATE RETURN" APPROACH?

1 A. The “separate return” methodology calculates income taxes on utility revenues and
2 expenses that are included in the utility’s revenue requirement. This approach
3 appropriately allocates income taxes between customers and shareholders using a
4 benefits/burdens criteria. Under this methodology, income tax expense relates to, and
5 results from, the provision of utility service to customers. Additionally, the “separate
6 return” income tax calculation includes an adjustment to synchronize interest.
7 Synchronized interest represents the portion of return which is deductible for tax
8 purposes, and is calculated by multiplying the weighted cost of debt by rate base. Use
9 of synchronized interest in the tax calculation effectively “synchronizes” the
10 calculation of income tax expense with rate base and rate of return. It calculates income
11 taxes consistent with the assumptions used to calculate rate base and the rate of return.
12 Synchronized interest may be more or less than the actual interest deducted on the tax
13 return.

14 Q. WHY IS THE “SEPARATE RETURN” APPROACH THE PROPER
15 METHODOLOGY TO USE IN CALCULATING FEDERAL INCOME TAXES FOR
16 RATEMAKING PURPOSES?

17 A. The “separate return” approach includes in the cost of service only income taxes that
18 result from the provision of utility service to customers and, as explained below, is
19 consistent with the Public Utility Regulatory Act (PURA). Federal income taxes
20 requested by the Company are based on revenues and expenses included in the cost of
21 service calculation. There are no additions to or reductions from tax expense resulting
22 from revenues or expenses not included in the Company’s request. It is neither
23 appropriate nor equitable to increase or reduce cost of service by tax costs or benefits

1 that are not related to the rendition of utility service to customers. The use of a separate
2 return approach prevents the cross-subsidization of costs or benefits among affiliate
3 companies. Normalization requires consistency among tax expense, book depreciation
4 expense, rate base, and the deferred tax reserve.⁵

5 Q. HAS THE COMPANY COMPUTED FEDERAL INCOME TAXES IN
6 ACCORDANCE WITH SECTIONS 36.059 AND 36.060 OF PURA?

7 A. Yes. PURA §§ 36.059 and 36.060 address the treatment of certain tax benefits,
8 including ITC and consolidated tax savings. Both sections (PURA §36.059(b) and
9 §36.060(c)) specifically require a utility that retains ITC to deduct it from the rate base
10 to which the credit applied, to the extent allowed by the Code. The unamortized
11 balance of ITC is not included as a reduction of rate base because the Company is an
12 “Option 2” company for ITC purposes. Under IRC §46(f), an “Option 2” election
13 requires that the post-1970 ITC be returned to customers over the book life of the
14 property as a reduction of cost of service, rather than as a reduction of rate base. The
15 unamortized balance consists entirely of post-1970 ITC.

16 Additionally, §36.060(b) requires that income taxes related to intercompany
17 profits on affiliated purchases be applied to reduce the cost of the property or service
18 purchased. All transactions among affiliates are at cost and there are no intercompany
19 profits included in the Company’s costs. As a result, tax expense included in this filing
20 has been calculated in accordance with PURA § 36.060(b).

⁵ 26 U.S.C. § 168(i)(9)(B).

1 Further, PURA § 36.060(a) requires that income tax expense included in cost
2 of service reflect only expenses and investments included in cost of service and rate
3 base. The Company's income tax amounts included in cost of service are consistent
4 with this provision.

5
6 VII. TAX CUTS AND JOBS ACT OF 2017

7 Q. PLEASE DISCUSS THE PRIMARY RATE MAKING IMPACT OF THE TCJA.

8 A. While there were numerous changes in tax law as a result of the TCJA, the primary
9 impact on rate making is the reduction of the corporate income tax rate from 35 percent
10 to 21 percent beginning with the 2018 tax year, which led to the creation of a new
11 balance of Excess ADFIT for the Company.

12 Q. WHAT IS EXCESS ADFIT?

13 A. ADFIT arises due to temporary differences such as the accelerated depreciation and
14 bonus depreciation provisions of the Code that can result in corporations, such as the
15 Company, recovering through rates their federal corporate income tax expense at a
16 different (initially faster) rate than they pay the associated taxes. Upon remeasurement
17 of ADFIT following the passage of the TCJA, SWEPCO, as a regulated utility
18 following Financial ASC 980, deferred this difference on the Company's books as a
19 regulatory liability. If income tax rates had remained the same, the deferral would have
20 been reversed in later years as the Company paid its current federal corporate income
21 tax expense at a rate that was greater than the Company was recovering through rates.
22 When the federal corporate income tax rate is reduced, as happened with the TCJA,

1 and all other things being equal, a portion of the deferral will never be paid and thus
2 becomes “excess.” There are two types of excess ADFIT, protected and unprotected.

3 Q. WHAT ARE PROTECTED AND UNPROTECTED EXCESS ADFIT?

4 A. There are two components of excess ADFIT – “normalized” or “protected” excess
5 ADFIT and “non-normalized” or “unprotected” excess ADFIT. Protected excess
6 ADFIT is related only to temporary differences that arise due to differences in the
7 method and life used in calculating depreciation for tax purposes and for book
8 purposes. Given the nature of the temporary differences that give rise to this excess
9 ADFIT it is considered to be “protected” by the normalization requirements within the
10 Code. Excess ADFIT associated with all other timing differences is unprotected.
11 These two components are treated differently under the Code. Specifically, the Tax
12 Cuts and Jobs Act (TCJA) requires that protected excess ADFIT be amortized over
13 “the remaining lives of the property as used in its regulated books of account which
14 gave rise to the reserve for deferred taxes.” See TCJA Subtitle C, Part I, Sec.
15 13001(d)(3)(B). For SWEPCO this amortization period is based on the Average Rate
16 Assumption Method or “ARAM.”⁶ Neither the Code nor the TCJA establish
17 restrictions on the manner or time for sharing unprotected excess ADFIT. The
18 Company is proposing in this filing to utilize the balance of unprotected excess ADFIT,
19 and the protected excess ADFIT amount amortized between January 1, 2018 and the
20 beginning of the test year, to offset the unrecovered cost of the Dolet Hills Power
21 Station as described by Company witness Michael Baird. The Company has deferred

⁶ Internal Revenue Service, Rev. Proc. 2020-39 (August 14, 2020).

1 the income statement benefit of the protected excess ADFIT amortization to a provision
2 for refund liability account as described by Company witness Michael Baird.

3 Q. PLEASE DESCRIBE THE ARAM.

4 A. The ARAM reduces the excess tax reserve over the remaining regulatory lives of the
5 property that gave rise to the reserve for deferred taxes during the years in which the
6 deferred tax reserve related to such property is reversing. That is, when the tax
7 depreciation for a given asset becomes less than the book depreciation, the excess tax
8 reserve is reduced by the difference between the taxes required under the old 35 percent
9 rate (and other rates prior to 1993) and the taxes required under the new 21 percent rate.
10 The excess reserve is not reduced until, and then only to the degree, that tax benefits
11 for a given asset expire. The ARAM provides that the utility will not have to refund
12 excess taxes to ratepayers any faster than it would have had to pay those taxes to the
13 federal government had the tax rates not been reduced. Under the ARAM, a utility will
14 not have to change its cash management plan, because the excess tax reserve will be
15 refunded to customers at the same pace it would have been paid to the federal
16 government absent the tax rate reduction.

17 Q. ARE THERE CONSEQUENCES IF THE COMPANY AMORTIZES THE
18 PROTECTED EXCESS ADFIT MORE QUICKLY THAN ARAM PROVIDES?

19 A. Yes. TCJA section 13001(d)(4) provides that if an excess reserve is reduced more
20 rapidly or to a greater extent than the reserve would be reduced under the ARAM, 1)
21 the Company's tax for the taxable year will be increased by the amount by which it
22 reduces its excess tax reserves more rapidly than permitted under a normalization
23 method of accounting; and 2) the Company would not be treated as using a

1 normalization method of accounting for purposes of section 168(f)(2) and (i)(9)(C) of
2 the Code, i.e., the Company would have violated the normalization rules. The
3 punishment for a normalization violation is discussed earlier in my testimony.

4 Q. HAS THE COMPANY PRESENTED IN THIS FILING THE BALANCE OF EDFIT
5 THAT SHOULD BE PASSED BACK TO CUSTOMERS?

6 A. Yes. The total company unamortized balance of protected EDFIT is presented in
7 Schedule G-7.9a in the amount of \$486,745,961. This balance represents the
8 unamortized balance that is expected to be returned to all customers of the Company
9 regardless of jurisdiction. The unamortized balance of protected EDFIT to be returned
10 to Texas customers is \$121,725,475. The Company is proposing in this filing to utilize
11 the Texas jurisdictional balance of unamortized unprotected EDFIT of \$17,337,163 to
12 partially offset the unrecovered cost of the Dolet Hills Power Station as discussed in
13 the testimony of Company witness Michael Baird.

14 Q. HAS THE COMPANY RECORDED AMORTIZATION OF PROTECTED EDFIT
15 SINCE THE ENACTMENT OF TCJA?

16 A. Yes. Under the ARAM, the protected amortization of EDFIT began January 1, 2018 –
17 immediately after the effect of the federal rate change due to TCJA. This deferred tax
18 benefit was deferred on the Company’s income statement through a provision for
19 revenue refund as described in the testimony of Company witness Michael Baird.

20 Q. HAS THE COMPANY INCLUDED AN EDFIT BALANCE RELATED TO NOL
21 CARRYFORWARDS WITH ITS PROTECTED OR UNPROTECTED BALANCE?

22 A. The Company has included an EDFIT balance related to NOLC as a component of the
23 protected EDFIT as presented in Schedule G-7.9a. As the “with-and-without” test

1 described earlier in my testimony determined that the NOLC was a result of accelerated
2 depreciation and therefore subject to the normalization rules, it also follows that the
3 EDFIT associated with the NOLC should also be subject to the normalization rules and
4 categorized as protected. The NOL EDFIT is therefore simply an offset, or reduction,
5 to the EDFIT associated with accelerated depreciation.

6 Q. PLEASE EXPLAIN THE TEST YEAR AMORTIZATION ADJUSTMENT AS SEEN
7 ON SCHEDULE G-7.9.

8 A. The \$4,664,032 adjustment to the test year amortization of protected EDFIT is a rate
9 making adjustment to reflect the impact on the amortization from the EDFIT associated
10 with the Company's NOLC as presented on Schedule G-7.13f. This represents the
11 amortization of the initial deficient DFIT balance of \$194,453,551 as presented on
12 Schedule G-7.13f as a result in the tax rate change from TCJA. The EDFIT associated
13 with the NOLC is being amortized using the ARAM based on the assets giving rise to
14 the taxable losses.

15 Q. PLEASE EXPLAIN THE \$10,042,883 ADJUSTMENT TO ADFIT IN RATE BASE
16 AS SHOWN ON SCHEDULE G-7.4b – ADJUSTMENT SUPPORT.

17 A. This adjustment is a rate making adjustment to reflect the cumulative impact on ADFIT
18 associated with the amortization of the Company's NOLC as discussed above. This
19 adjustment is the sum of the \$4,664,032 amortization during the test period as described
20 above in my testimony, as well as \$5,378,851 of amortization for the period of January
21 1, 2018 until the beginning of the test period. As the deficient DFIT is amortized there
22 is a resulting decrease in the overall ADFIT credit balance.

VIII. PROFORMA ADJUSTMENTS

1
2 Q. WHAT PRO FORMA ADJUSTMENTS HAVE BEEN MADE TO SWEPKO'S
3 HISTORICAL TEST YEAR CALCULATION OF FEDERAL INCOME TAXES?

4 A. Four kinds of pro forma adjustments have been included in the calculation of federal
5 income tax expense: 1) adjustments to include the tax effects of other adjustments to
6 cost of service; 2) adjustments to remove any income tax expense recorded in the
7 historical test year that was related to periods outside the test year; 3) an adjustment to
8 synchronize the deduction of interest for federal income tax purposes; and 4)
9 adjustments to tax amortizations to reflect a pro forma level of amortization of ITC and
10 EDFIT. The adjustments to protected EDFIT are set out on Highly Sensitive Exhibit
11 DAH-8.

12 Q. CAN YOU SPECIFICALLY IDENTIFY THE ADJUSTMENTS MADE FOR THE
13 CALCULATION OF FEDERAL INCOME TAX EXPENSE?

14 A. Yes. RFP Schedule G-7.6 provides details of the impacts of pro forma adjustments
15 made for the calculation of the test year federal income tax expense.

16 Q. WHAT IS REPRESENTED BY ADFIT INCLUDED IN RATE BASE FOR THE
17 HISTORICAL TEST YEAR?

18 A. The ADFIT amounts reflected on Schedule G-7.4 for the historical year represent
19 balances associated with the rate base balances at March 31, 2020, adjusted for pro
20 forma changes.

21 Q. WHAT PRO FORMA ADJUSTMENTS HAVE BEEN MADE TO ADFIT, AS
22 RECORDED, TO ARRIVE AT BALANCES SHOWN ON THE HISTORICAL TEST
23 YEAR SCHEDULES?

1 A. Pro forma adjustments made to the ADFIT balance as of March 31, 2020 include the
2 following: 1) adjustments to ADFIT related to pro forma adjustments to other rate base
3 items; 2) adjustments made for ratemaking purposes, such as removing ADFIT that
4 does not relate to the Texas jurisdiction and reducing ADFIT by the NOLC balance;
5 and 3) adjustments made to ADFIT related to balances that are not related to electric
6 service.

7 Q. CAN YOU SPECIFICALLY IDENTIFY ADJUSTMENTS MADE TO ADFIT YOU
8 JUST DESCRIBED?

9 A. Yes. RFP Schedule G-7.4b provides the adjustments and the explanation of the
10 adjustments made to historical test year ADFIT.

11 Q. CAN YOU DISCUSS THE PRO FORMA ADJUSTMENT TO RATE BASE FOR
12 THE NOL?

13 A. The pro forma adjustment of \$455,122,490 is being made to reduce the ADFIT balance
14 for an NOL calculated on a separate return basis. This adjustment represents the
15 amount of ADFIT associated with accelerated tax depreciation which has not been able
16 to produce cash benefits to the company on the basis of a separate tax return method as
17 of the end of the historic test year. The calculation of the amount of the NOL can be
18 seen on Schedule G-7.13f. This adjustment reflects the ADFIT associated with the
19 taxable losses the Company has generated in excess of the taxable income it has
20 generated and been able to offset based on the NOLC and carryback provisions of the
21 Code.

1 Q. WAS A “WITH-AND-WITHOUT” OR “LAST DOLLAR DEDUCTED” ANALYSIS
2 DONE TO DETERMINE THE AMOUNT OF NOL SUBJECT TO THE
3 REQUIREMENTS OF NORMALIZATION?

4 A. Yes. A “with-and-without” calculation was performed to determine the amount of the
5 NOL required to reduce the ADFIT balance. This calculation determined that all of the
6 \$455,122,490 NOLC is a result of accelerated tax depreciation and therefore subject to
7 the normalization rules as described previously in my testimony.

8 Q. WHY IS IT APPROPRIATE TO INCLUDE THIS NOL CARRYFORWARD IN
9 RATE BASE?

10 A. It is appropriate to include the NOLC as a decrease to the ADFIT balance because of
11 the normalization rules discussed earlier in my testimony and also in accordance with
12 the requirements of PURA § 36.060 and 16 TAC §25.231(b)(1)(D). The cash benefits
13 from deductions taken for accelerated depreciation should not be passed to customers
14 any sooner than cash benefits would be received by the Company if filing a separate
15 return. The inclusion of the NOL offsets the rate base reduction associated with
16 deferred tax liabilities (DTLs) for accelerated depreciation for which the Company
17 would not yet receive a cash benefit for on a separate return basis.

18

19 IX. CONCLUSION

20 Q. PLEASE SUMMARIZE YOUR CONCLUSIONS.

21 A. The federal income tax schedules that are part of this filing are in compliance with the
22 prescribed RFP and are in accordance with applicable law and the Substantive Rules
23 of this Commission. Adjustments made to tax expense, cost of service, and to rate base

1 are both appropriate and fair. The tax expense in the cost of service and ADFIT in rate
2 base both correctly reflect the costs and benefits of the regulated utility operations of
3 the Company on a separate return basis. Accordingly, the Company's request to
4 include the amount of federal income tax expense that is included in the cost of service
5 reflected on Schedule G-7 should be granted.

6 Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

7 A. Yes, it does.

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2014

PLR/TAM 201436057 - 201436001

PLR 201436037 -- IRC Sec(s). 167; 168, 09/05/14

Private Letter Rulings

Private Letter Ruling 201436037, 09/05/14, IRC Sec(s). 167

UIL No. 167.22-01

Accelerated depreciation-accumulated deferred income tax-net operating loss carryover-computation based on with or without basis-normalization-limitations on reasonable allowance in case of property of public utilities.

Headnote:

Reduction of regulated electric utility's rate base by full amount of its ADIT account balances offset by portion of its NOLC-related account that is less than amount attributable to accelerated depreciation computed on "with or without" basis would be inconsistent with Code Sec. 168(i)(9), and Reg § 1.167(l)-1 requirements.

Reference(s): Code Sec. 167; Code Sec. 168;

Full Text:

Number: **201436037**

Release Date: 9/5/2014

Index Number: 167.22-01

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact: [Redacted Text]

[Redacted Text], ID No.

Telephone Number: [Redacted Text]

Refer Reply To:

CC PSI.B06

PLR-148310-13

Date:

May 22, 2014

LEGEND:

Taxpayer =

Parent =

State A =

State B =

State C =

Commission A =

Commission B =

Commission C =

Year A =

Year B =

Date A =

Date B =

Date C =

Case =

Director =

Dear [Redacted Text]:

This letter responds to the request, dated November 25, 2013, of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated public utility incorporated in State A and State B. It is wholly owned by Parent. Taxpayer is engaged in the transmission, distribution, and supply of electricity in State A and State C. Taxpayer is subject to the regulatory jurisdiction of Commission A, Commission B, and Commission C with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis. Taxpayer takes accelerated depreciation, including "bonus depreciation" where available and, for each year beginning in Year A and ending in Year B, Taxpayer individually (as well as the consolidated return filed by Parent) has or expects to, produce a net operating loss (NOL). On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries - a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of a net operating loss carryover (NOLC). Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a "with or without" methodology, meaning that an NOLC is attributable to accelerated depreciation to the extent of the lesser of the accelerated depreciation or the NOLC.







Taxpayer filed a general rate case with Commission B on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission B policy and were not flowed thru to ratepayers. The data originally filed in Case included six months of forecast data, which the Taxpayer updated with actual data in the course of proceedings. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission B offset rate base by Taxpayer's ADIT balance, using a 13-month average of the month-end balances of

the relevant accounts. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Testimony by various other participants in Case argued against Taxpayer's proposed calculation of ADIT. One proposal made to Commission B was, if Commission B allowed Taxpayer to reduce the ADIT balance as Taxpayer proposed, then Taxpayer's income tax expense element of service should be reduced by that same amount.




Commission B, in an order issued on Date C, allowed Taxpayer to reduce ADIT by the amount that Taxpayer calculates did not actually defer tax due to the presence of the NOLC and ordered Taxpayer to seek a ruling on the effects of an NOLC on ADIT. Rates went into effect on Date C.


Taxpayer proposed, and Commission B accepted, that it be permitted to annualize, rather than average, its reliability plant additions and to extend the period of anticipated reliability plant additions to be included in rate base for an additional quarter. Taxpayer also proposed, and Commission B accepted, that no additional ADIT be reflected as a result of these adjustments inasmuch as any additional book and tax depreciation produced by considering these assets would simply increase Taxpayer's NOLC and thus there would be no net impact on ADIT.





Taxpayer requests that we rule as follows:





1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations
2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1.
3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1.






Law and Analysis


 Section 168(f)(2) of the Code provides that the depreciation deduction determined under  section 168 shall not apply to any public utility property (within the meaning of  section 168(i)(10)) if the taxpayer does not use a normalization method of accounting


In order to use a normalization method of accounting,  section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes



and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under  section 168(i)(9)(A)(ii), if the amount allowable as a deduction under  section 168 differs from the amount that would be allowable as a deduction under  section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under  section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.





 Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of  section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under  section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under  section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base



Former  section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former  section 167(l)(3)(G) in a manner consistent with that found in  section 168(i)(9)(A).  Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under  section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items



 Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

 Section 1.167(1)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This

amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under  section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under  section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

 Section 1.167(1)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under  section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under  section 1.167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under  section 167(a).

 Section 1.167(1)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under  section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

 Section 1.167(1)-(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under  section 1.167(1)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

In Case, Commission B has reduced rate base by Taxpayer's ADIT account, as modified by the account which Taxpayer has designed to calculate the effects of the NOLC.







Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission B is in accord with the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the second issue, § 1.167(1)-(h)(6)(i) provides, as noted above, that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Increasing Taxpayer's ADIT

account by an amount representing those taxes that would have been deferred absent the NOLC increases the ADIT reserve account (which will then reduce rate base) beyond the permissible amount.


Regarding the third issue, reduction of Taxpayer's tax expense element of cost of service, we believe that such reduction would, in effect, flow through the tax benefits of accelerated depreciation deductions through to rate payers even though the Taxpayer has not yet realized such benefits. This would violate the normalization provisions.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with or without" basis would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations.
2. The imputation of incremental ADIT on account of the reliability plant addition adjustments described above would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1.
3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it.  Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman

Senior Technician Reviewer, Branch 6

(Passthroughs & Special Industries)

cc: [Redacted Text]

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2014

PLR/TAM 201438036 - 201438001

PLR 201438003 -- IRC Sec(s). 167; 168, 09/19/2014

Private Letter Rulings

Private Letter Ruling 201438003, 09/19/2014, IRC Sec(s). 168

UIL No. 167.22-01

Accelerated depreciation-accumulated deferred income tax-net operating loss carryover-normalization-limitations on reasonable allowance in case of property of public utilities.

Headnote:

Reduction of taxpayer/regulated electric utility's rate base by full amount of its ADIT account balance unreduced by balance of NOLC-related account balance would be inconsistent with Code Sec. 168(i)(9); and Reg § 1.167(l)-1 requirements.

Reference(s): Code Sec. 168; Code Sec. 167;

Full Text:

Number: **201438003**

Release Date: 9/19/2014

Index Number: 167.22-01

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact: [Redacted Text]

[Redacted Text], ID No.

Telephone Number: [Redacted Text]

Refer Reply To:

CC:PSI-B06

PLR-104157-14

Date.

June 12, 2014

LEGEND:

Taxpayer =

Parent =

State A =

Commission A =

Commission B =

Year A =

Year B =

Year C =

Year D =

Date A =

Date B =

Date C =

Date D =

Case =

Director =

Dear [Redacted Text]:

This letter responds to the request, dated January 24, 2014, and additional submission dated May 19, 2014, submitted on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated, investor-owned public utility incorporated under the laws of State A primarily engaged in the business of supplying electricity in State A. Taxpayer is subject to the regulatory jurisdiction of Commission A and Commission B with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis.

Taxpayer is wholly owned by Parent, and Taxpayer is included in a consolidated federal income tax return of which Parent is the common parent. Taxpayer employs the accrual method of accounting and reports on a calendar year basis.

Taxpayer filed a rate case application on Date A (Case). In its filing, Taxpayer used as its starting point actual data from the historic test period, calendar Year A. It then projected data for Year B through Year C. Taxpayer updated, amended, and supplemented its data several times during the course of the proceedings. Rates in this proceeding were intended to, and did, go into effect for the period Date B through Date C.

In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized and were not flowed thru to ratepayers.

In its rate case filing, Taxpayer anticipated that it would claim accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available in all years for which data was provided. Additionally, Taxpayer forecasted that it would incur a net operating loss (NOL) in Year D. Taxpayer anticipated that it had the capacity to carry back a portion of this NOL with the remainder producing a net operating loss carryover (NOLC) as of the end of Year D.







On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting

series of entries - a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an NOLC.

In the setting of utility rates in State, a utility's rate base is offset by its ADIT balance. In its rate case filing and throughout the proceeding, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced as of the end of Year D by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It based this position on its determination that this net amount represented the true measure of federal income taxes deferred on account of its claiming accelerated tax depreciation deductions and, consequently, the actual quantity of "cost-free" capital available to it. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules. Testimony by another participant in Case argued against Taxpayer's proposed calculation of ADIT.

Commission A, in an order issued on Date D, held that it is inappropriate to include the NOL in rate base for ratemaking purposes. Commission A further stated that it is the intent of the Commission that Taxpayer comply with the normalization method of accounting and tax normalization regulations. Commission noted that if Taxpayer later obtains a ruling from the IRS which affirms Taxpayer's position, Taxpayer may file seeking an adjustment. Commission A also held that to the extent tax normalization rules require recording the NOL to rate base in the specified years, no rate of return is authorized.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations.
2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with (and, hence, violative of) the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations.
3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of  § 168(i)(9) and  § 1.167(l)-1.

Law and Analysis

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should


reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.




Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).


Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.



Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax

expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under  section 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

 Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so.  Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. 

Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.







Regarding the first issue,  § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission A is not in accord with the normalization requirements.

Regarding the second issue,  § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes.  Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. While that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the

amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.


Regarding the third issue, assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would, in effect, flow the tax benefits of accelerated depreciation deductions through to rate payers. This would violate the normalization provisions.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations.
2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations.
3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it.  Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman

Senior Technician Reviewer, Branch 6

(Passthroughs & Special Industries)

cc: [Redacted Text]

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Private Letter Rulings & Technical Advice Memoranda (1950 to Present)

2015

PLR/TAM 201519028 - 201519001

PLR 201519021 -- IRC Sec(s). 167; 168, 05/08/2015

Private Letter Rulings

Private Letter Ruling 201519021, 05/08/2015, IRC Sec(s). 168

UIL No. 167.22-01

Accelerated depreciation-accumulated deferred income tax-net operating loss carryover-normalization-limitations on reasonable allowance in case of property of public utilities.

Headnote:

Reduction of taxpayer/investor-owned public utility's rate base by full amount of its ADIT account balance unreduced by balance of NOLC-related account balance would be inconsistent with Code Sec. 168(i)(9); and Reg § 1.167(l)-1 requirements.

Reference(s): Code Sec. 168; Code Sec. 167;

Full Text:

Number: **201519021**

Release Date: 5/8/2015

Index Number: 167.22-01

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact: [Redacted Text]

[Redacted Text], ID No.

Telephone Number: [Redacted Text]

Refer Reply To:

CC.PSI:B06

PLR-136851-14

Date.

February 04, 2015

LEGEND:

Taxpayer =

Parent =

State A =

Commission =

Year A =

Year B =

Year C =

Year D =

Date A =

Date B =

Date C =

Date D =

Case =

Director =

Dear [Redacted Text]:

This letter responds to the request, dated October 1, 2014, submitted on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is a regulated, investor-owned public utility incorporated under the laws of State A primarily engaged in the business of supplying natural gas service in State A. Taxpayer is subject to the regulatory jurisdiction of Commission with respect to terms and conditions of service and as to the rates it may charge for the provision of service. Taxpayer's rates are established on a cost of service basis.

Taxpayer is wholly owned by Parent, and Taxpayer is included in a consolidated federal income tax return of which Parent is the common parent. Taxpayer employs the accrual method of accounting and reports on a calendar year basis.

Taxpayer filed a rate case application on Date A (Case). In its filing, Taxpayer used as its starting point actual data from the historic test period, calendar Year A. It then projected data for Year B through Year D. Taxpayer updated, amended, and supplemented its data several times during the course of the proceedings. Rates in this proceeding were intended to, and did, go into effect for the period Date B through Date C.

In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized and were not flowed thru to ratepayers.

In its rate case filing, Taxpayer anticipated that it would claim accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available in all years for which data was provided. Additionally, Taxpayer forecasted that it would incur a net operating loss (NOL) in each of Year B, Year C, and Year D. Taxpayer anticipated that it had the capacity to carry back a portion of this NOL with the remainder producing a net operating loss carryover (NOLC) as of the end of Year C and Year D, the beginning and end of the test period.







On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries - a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the

existence of an NOLC.




In the setting of utility rates in State, a utility's rate base is offset by its ADIT balance. In its rate case filing and throughout the proceeding, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced as of the end of Year D by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It based this position on its determination that this net amount represented the true measure of federal income taxes deferred on account of its claiming accelerated tax depreciation deductions and, consequently, the actual quantity of "cost-free" capital available to it. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules Testimony by another participant in Case argued against Taxpayer's proposed calculation of ADIT.

Commission, in an order issued on Date D, held that it is inappropriate to include the NOL in rate base for ratemaking purposes. Commission further stated that it is the intent of the Commission that Taxpayer comply with the normalization method of accounting and tax normalization regulations. Commission noted that if Taxpayer later obtains a ruling from the IRS which affirms Taxpayer's position, Taxpayer may file seeking an adjustment. Commission also held that to the extent tax normalization rules require including the NOL in rate base in the specified years, no rate of return is authorized.






Taxpayer requests that we rule as follows:





1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations.
2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with (and, hence, violative of) the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations.
3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of  § 168(i)(9) and  § 1.167(l)-1.






Law and Analysis


 Section 168(f)(2) of the Code provides that the depreciation deduction determined under  section 168 shall not apply to any public utility property (within the meaning of  section 168(i)(10)) if

the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting,  section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under  section 168(i)(9)(A)(ii), if the amount allowable as a deduction under  section 168 differs from the amount that would be allowable as a deduction under  section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under  section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

 Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of  section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under  section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under  section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former  section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former  section 167(l)(3)(G) in a manner consistent with that found in  section 168(i)(9)(A).  Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under  section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

 Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.




Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).


Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.



Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(l)-1(h)(2)(i)) at the end of the historical period. If

such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

 Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so.  Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. 

Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.







Regarding the first issue,  § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the order by Commission is not in accord with the normalization requirements.

Regarding the second issue,  § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes.  Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. While that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers.

Under these specific facts, any method other than the "with and without" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.


Regarding the third issue, assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would, in effect, flow the tax benefits of accelerated depreciation deductions through to rate payers. This would violate the normalization provisions.

We rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations.
2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "with and without" basis would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations.
3. Under the circumstances described above, the assignment of a zero rate of return to the balance of Taxpayer's NOLC-related account balance would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it.  Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman

Senior Technician Reviewer, Branch 6

Office of the Associate Chief Counsel

(Passthroughs & Special Industries)

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2015

PLR/TAM 201534020 - 201534001

PLR 201534001 -- IRC Sec(s). 167; 168, 08/21/2015

Private Letter Rulings

Private Letter Ruling 201534001, 08/21/2015, IRC Sec(s). 168

UIL No. 167.22-01

**Accelerated depreciation-accumulated deferred income
tax-net operating loss
carryforward-normalization-limitations on reasonable
allowance in case of property of public utilities.**

Headnote:

Reduction of taxpayer/common parent/regulator's rate base by full amount of its ADIT account balance unreduced by balance of NOLC-related account balance would be inconsistent with Code Sec. 168(i)(9); and Reg § 1.167(l)-1 requirements.

Reference(s): Code Sec. 168; Code Sec. 167;

Full Text:

Number: **201534001**

Release Date: 8/21/2015

Index Number: 167.22-01

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact: [Redacted Text]

[Redacted Text], ID No.

Telephone Number: [Redacted Text]

Refer Reply To:

CC:PSI:B06

PLR-103300-15

Date:

May 13, 2015

LEGEND:

Taxpayer =

State A =

State B =

State C =

Commission =

Year A =

Year B =

Date A =

Date B =

Date C =

Date D =

Case =

Director =

Dear [Redacted Text].

This letter responds to the request, dated January 9, 2015, submitted on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is the common parent of an affiliated group of corporations and is incorporated under the laws of State A and State B. Taxpayer is engaged primarily in the businesses of regulated natural gas distribution, regulated natural gas transmission, and regulated natural gas storage. Taxpayer's regulated natural gas distribution business delivers gas to customers in several states, including State A. Taxpayer is subject to, as relevant for this ruling, the regulatory jurisdiction of Commission with respect to terms and conditions of service and as to the rates it may charge for the provision of its gas distribution service in State A. Taxpayer's rates are established on a "rate of return" basis.





Taxpayer filed a rate case application on Date A (Case). In its filing, Taxpayer's application was based on a fully forecasted test period consisting of the twelve months ending on Date B. Taxpayer updated, amended, and supplemented its data several times during the course of the proceedings. In a final order dated Date C, rates were approved by Commission for service rendered on or after Date D.

In each year from Year A to Year B, Taxpayer incurred a net operating loss carryforward (NOLC). In each of these years, Taxpayer claimed accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available. On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries - a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an NOLC.




In the setting of utility rates in State C, a utility's rate base is offset by its ADIT balance. In its rate case filing and throughout the proceeding, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules. The attorney general for State C argued against Taxpayer's proposed calculation of ADIT.






Commission, in its final order, agreed with Taxpayer but concluded that the ambiguity in the relevant normalization regulations warranted an assessment of the issue by the IRS and this ruling request followed.





Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with (and, hence, violative of) the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations.
2. For purposes of Ruling 1 above, the use of a balance of Taxpayer's NOLC-related account that is less than the amount attributable to accelerated depreciation computed on a "last dollars deducted" basis would be inconsistent with (and, hence, violative of) the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations.






Law and Analysis


 Section 168(f)(2) of the Code provides that the depreciation deduction determined under  section 168 shall not apply to any public utility property (within the meaning of  section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.






In order to use a normalization method of accounting,  section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under  section 168(i)(9)(A)(ii), if the amount allowable as a deduction under  section 168 differs from the amount that would be allowable as a deduction under  section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under  section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.



 Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of  section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under  section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under  section 168(i)(9)(A)(ii),



unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.



Former  section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former  section 167(l)(3)(G) in a manner consistent with that found in  section 168(i)(9)(A).  Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under  section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items



 Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.




 Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a  subsection (1) method for purposes of determining the taxpayer's reasonable allowance under  section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under  section 167(a) using a  subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

 Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under  section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount


for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under  section 1 167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under  section 167(a)



 Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under  section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.



 Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under  section 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

 Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so.  Section 1 167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. 

Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.


Regarding the first issue,  § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of

capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, to reduce Taxpayer's rate base by the full amount of its ADIT account balance unreduced by the balance of its NOLC-related account balance would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1.

Regarding the second issue,  § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes.  Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. While that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements. The "last dollars deducted" methodology employed by Taxpayer ensures that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these specific facts, any method other than the "last dollars deducted" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it.  Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman

Senior Technician Reviewer, Branch 6

Office of the Associate Chief Counsel

o (Passthroughs & Special Industries)

cc: [Redacted Text]

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PLR/TAM 201548027 - 201548001

PLR 201548017 -- IRC Sec(s). 167; 168, 11/27/2015

Private Letter Rulings

Private Letter Ruling 201548017, 11/27/2015, IRC Sec(s). 168

UIL No. 167.22-01

**Accelerated depreciation-accumulated deferred income
tax-net operating loss
carryforward-normalization-limitations on reasonable
allowance in case of property of public utilities.**

Headnote:

Reduction of taxpayer/regulator's natural gas distributor's rate base by balance of its ADIT accounts unreduced by its NOLC-related deferred tax account, by full amount of its ADIT account balances offset by portion of NOLC-related account balances, or any reduction in taxpayer's tax expense element of cost of service to reflect tax benefit of its NOLC would be inconsistent with Code Sec. 168(i)(9); and Reg § 1.167(l)-1 requirements.

Reference(s): Code Sec. 168; Code Sec. 167;

Full Text:

Number: **201548017**

Release Date: 11/27/2015

Index Number: 167.22-01

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact: [Redacted Text]

[Redacted Text], ID No.

Telephone Number: [Redacted Text]

Refer Reply To:

CC-PSI:B06

PLR-116998-15

Date:

August 19, 2015

LEGEND:

Taxpayer =

Parent =

State A =

State B =

Commission =

Year A =

Year B =

Date A =

Date B =

Case =

Director =

Dear [Redacted Text]:

This letter responds to the request, dated May 14, 2015, of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is primarily engaged in the regulated distribution of natural gas in State A. It is incorporated in State B and is wholly owned by Parent. Taxpayer is subject to the regulatory jurisdiction of Commission with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer's rates are established on a rate of return basis. Taxpayer takes accelerated depreciation, including "bonus depreciation" where available and, for each year beginning in Year A and ending in Year B, Taxpayer incurred net operating losses (NOL). On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries - a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an net operating loss carryover (NOLC). Taxpayer, for normalization purposes, calculates the portion of the NOLC attributable to accelerated depreciation using a "last dollars deducted" methodology, meaning that an NOLC is attributable to accelerated depreciation to the extent of the lesser of the accelerated depreciation or the NOLC.

Taxpayer filed a general rate case with Commission on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission policy and were not flowed thru to ratepayers. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission offsets rate base by Taxpayer's ADIT balance. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Testimony by various other participants in Case argued against Taxpayer's proposed calculation of ADIT. One proposal made to Commission was, if Commission allowed Taxpayer to reduce the ADIT balance as Taxpayer proposed, then an offsetting reduction should be made to Taxpayer's income tax expense element of service.

A Utility Law Judge upheld Taxpayer's position with respect to the NOLC-related ADIT and ordered Taxpayer to seek a ruling from the Internal Revenue Service on this matter. This request is in response to that order.

Taxpayer requests that we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the balance of its ADIT accounts unreduced by its NOLC-related deferred tax account would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.
2. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "last dollars deducted" basis would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.
3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of § 168(i)(9) and § 1.167(l)-1.






Law and Analysis


Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.






In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.



Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii),



unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base



Former  section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former  section 167(l)(3)(G) in a manner consistent with that found in  section 168(i)(9)(A).  Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under  section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.



 Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.




 Section 1.167(1)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a  subsection (1) method for purposes of determining the taxpayer's reasonable allowance under  section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under  section 167(a) using a  subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

 Section 1.167(1)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under  section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount



for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under  section 1 167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under  section 167(a).

 Section 1.167(1)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under  section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.


 Section 1 167(1)-(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under  section 1.167(1)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

 Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so.  Section 1 167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. 

Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.





 Section 1.167(1)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Further, while that section provides no specific mandate on methods, it does provide that the Service has discretion to determine whether a particular method satisfies the normalization requirements.  Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a

normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the ADIT account, the reserve account for deferred taxes, reduces rate base, it is clear that the portion of an NOLC that is attributable to accelerated depreciation must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT). Thus, the proposed order by the Utility Law Judge upholding Taxpayer's position that the NOLC-related deferred tax account must be included in the calculation of Taxpayer's ADIT is in accord with the normalization requirements. The "last dollars deducted" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated depreciation to ratepayers. Under these facts, any method other than the "last dollars deducted" method would not provide the same level of certainty and therefore the use of any other methodology is inconsistent with the normalization rules.

Regarding the third issue, reduction of Taxpayer's tax expense element of cost of service, we believe that such reduction would, in effect, flow through the tax benefits of accelerated depreciation deductions through to rate payers even though the Taxpayer has not yet realized such benefits. In addition, such adjustment would be made specifically to mitigate the effect of the normalization rules in the calculation of Taxpayer's NOLC-related ADIT. In general, taxpayers may not adopt any accounting treatment that directly or indirectly circumvents the normalization rules. See generally,  §

1.46-6(b)(2)(ii) (In determining whether, or to what extent, the investment tax credit has been used to reduce cost of service, reference shall be made to any accounting treatment that affects cost of service); Rev. Proc 88-12, 1988-1 C.B. 637, 638 (It is a violation of the normalization rules for taxpayers to adopt any accounting treatment that, directly or indirectly flows excess tax reserves to ratepayers prior to the time that the amounts in the vintage accounts reverse). This "offsetting reduction" would violate the normalization provisions.

Based on the representations submitted by Taxpayer, we rule as follows:

1. Under the circumstances described above, the reduction of Taxpayer's rate base by the balance of its ADIT accounts unreduced by its NOLC-related deferred tax account would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1 of the Income Tax regulations.
2. Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account balances offset by a portion of its NOLC-related account balance that is less than the amount attributable to accelerated depreciation computed on a "last dollars deducted" basis would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1.